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IN THE

Supreme Court of the United States

OCTOBER TERM, 1974

No. 74-1471

TSC INDUSTRIES, INC., A DELAWARE CORPORATION, NATIONAL INDUSTRIES, INC., A KENTUCKY CORPORATION, AND TSC INDUSTRIES, INC. (FORMERLY NAMED NII, INC., AND BEING THE SUCCESSOR TO THE BUSINESS, ASSETS AND CORPORATE NAME OF SAID TSC INDUSTRIES, INC.),
Petitioners,

vs.

NORTHWAY, INC., A DELAWARE CORPORATION,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT.

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Petitioners,

vs.

NORTHWAY, INC., A DELAWARE CORPORATION,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT.

This is an action under the Securities Exchange Act of 1934 ("1934 Act") and related rules of the Securities and Exchange Commission ("SEC").

Petitioners (hereinafter "TSC" or "National") request that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Seventh Circuit (Chief Judge Swygert) reversing, on interlocutory appeal pursuant to 28 U. S. C. §1292(b), the denial by the United States District Court for the Northern District of Illinois (Judge Richard W. McLaren) of Respondent's motion for partial summary judg-

ment as to the liability of Petitioners. The other defendants, known collectively as the Schmidt defendants, have no interest in the outcome of this petition.

OPINIONS BELOW.

The opinion of the Court of Appeals has not been reported as of this time (A1-30).* Judge McLaren's Memorandum Opinion and Order of May 21, 1973, denying partial summary judgment as to the liability of Petitioners TSC and National, is reported at 361 F. Supp. 108 (A31-45). Judge McLaren's Memorandum Opinion and Order of August 10, 1973, amending the foregoing Order of May 21, 1973, is unreported (A46-48).

JURISDICTION.

The judgment of the Court of Appeals for the Seventh Circuit was entered March 5, 1975 (A1). This Court's jurisdiction is invoked under 28 U. S. C. §1254(1).

QUESTIONS PRESENTED FOR REVIEW.

1. Whether "materiality", under the federal securities laws' prohibition against materially false or misleading statements or omissions, requires only a showing of relevancy and possible importance to "some few stockholders," as the Seventh Circuit held, or whether it requires a stronger showing of "significant propensity" to affect shareholders' judgment as this Court stated in *Mills* v. *Electric Auto-Lite Co.*, 396 U. S. 375 (1970).

2. Whether the Seventh Circuit misused summary judgment, and hence improperly foreclosed TSC and National from a trial as to the issue of the materiality of the complained of omissions, by finding such omissions to be material as a matter of law?

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* All citations herein to "A" refer to the Appendix, *infra*, to this Petition. References to the separate four volume Joint Appendix in the Court of Appeals, which will be filed with the Clerk, are cited by volume number as "Vol."

STATUTES AND RULES INVOLVED.

Securities Exchange Act of 1934, § 14(a), 15 U. S. C. §78n(a) (A49).

Securities and Exchange Commission Rules 14a-9 and 405(a), (f), (n), 17 C. F. R. §§ 240.14a-9, 230.405(a), (f), (n) (A49-51).

Federal Rules of Civil Procedure, Rule 56(a), (b) and (c) (A51-52).

STATEMENT OF THE CASE.

This case arose out of the acquisition by National Industries, Inc. ("National"), a diversified company whose common shares are listed on the New York Stock Exchange, of substantially all of the assets of TSC Industries, Inc. ("TSC"), also a New York Stock Exchange listed company, which was engaged in the sale of repair and replacement parts for farm machinery and general retailing.

In February 1969, National purchased a substantial minority interest in TSC from Charles E. Schmidt, its founder. Including subsequent purchases, National's interest increased to approximately 34% of TSC's voting securities by October 1969. By that time five of the ten directors of TSC were National nominees. Shortly thereafter the Boards of Directors of both corporations approved, subject to shareholder approval, a transaction pursuant to which National acquired all of the assets of TSC in exchange for certain securities of National. Only those directors of TSC who were not nominated by National voted on the proposed transaction.

Respondent Northway, Inc. ("Plaintiff") is a corporation organized by an individual investor to hold his investments, including 200 shares of TSC. Plaintiff brought this derivative action pursuant to Section 27 of the Securities and Exchange Act of 1934 ("the 1934 Act") challenging the joint proxy statement

("Proxy Statement") furnished by TSC and National to their respective shareholders seeking approval of the proposed acquisition (Vol. III, Part 1, Ex. A to Complaint). Plaintiff claimed violations of various sections of the federal securities laws and related SEC Rules, including Rules 14a-9 and 10b-5 which forbid materially false or misleading statements or omissions.

Plaintiff moved for partial summary judgment before Judge McLaren against TSC and National on the issue of liability alone. The motion was based on the theory that certain omissions in the Proxy Statement were "material" as a matter of law and that consequently the Proxy Statement failed to comply with the disclosure requirements of the 1934 Act and the proxy rules issued thereunder. Plaintiff asserted that, among other things, the Proxy Statement was misleading in that it stated that the proposed sale of assets was approved by the Board of Directors of TSC without adequately disclosing facts regarding the relationship between TSC and National.

The Proxy Statement did, as Judge McLaren noted in his Opinion (A35, 37), "set forth under separate headings" at pages 6 and 7, (1) the approval of the sale to National by the TSC Board of Directors (such approval was by four disinterested members), (2) as well as the fact that National owned approximately 34% of the outstanding shares of TSC and (3) that five out of ten members of the TSC Board were National nominees (none of whom voted on the proposed sale).*

Pages 6 and 7 of the Proxy Statement are reproduced in full text at pp. 20-21 below as an exhibit to this petition. On these

* These headings, all appearing on page 6 of the Proxy Statement, read in equally-sized bold face type (p. 20 below):

BOARDS OF DIRECTORS APPROVAL

• • •

NATIONAL'S EQUITY INTEREST IN TSC

• • •

NATIONAL'S NOMINEES ON TSC'S BOARD

pages, all the essential facts as to National's interests in TSC were fully and prominently disclosed at the first point in the Proxy Statement where such disclosure was meaningful.

Plaintiff contended, however, that these disclosures were not adequate because the Proxy Statement did not disclose *in addition* (1) that National's president and executive vice president, who were specifically named as being among National's nominees on the TSC Board, were the chairman of the TSC Board and chairman of the Board's executive committee, respectively, and (2) that TSC and National in certain other reports previously filed with the SEC had stated the legal conclusion that National "may be a parent of TSC."

Pursuant to Rule 56 of the Federal Rules of Civil Procedure (A51-52) and confronted with conflicting deposition testimony and counteraffidavits, Judge McLaren held against Plaintiff on each ground of the motion either because Plaintiff failed to establish the absence of a genuine issue of material fact (A34, 35, 42, 43) or because Plaintiff was not entitled to judgment in its favor as a matter of law (A38, 40, 44). He identified the "pivotal question" on Plaintiff's motion for summary judgment as being whether these facts "relating to the relationship between TSC and National which were omitted from the joint proxy statement were, as a matter of law, material" (A34). Judge McLaren concluded (A38) that these and other omissions Plaintiff complained of were not material as a matter of law since reasonable men could differ on whether "these facts were so obviously important" as to "have a significant propensity to affect the voting process"—citing this Court's opinion in *Mills* v. *Electric Auto-Lite Co.*, 396 U. S. 375 (1970).

In reaching that conclusion Judge McLaren cited the "similar emphasis" which the Proxy Statement here gives "to the board's recommendation, National's equity interest in TSC, and the number and some of the positions of National's nominees"

(A37). Judge McLaren stressed that, consistent with the applicable regulatory requirements, he "considered the omitted facts in light of the manner in which other facts were disclosed which could have alerted the TSC shareholders to the possible bias of the management and board of TSC" (A38).

On interlocutory appeal pursuant to certification under 28 U. S. C. § 1292(b) (A46), the Seventh Circuit reversed Judge McLaren's denial of summary judgment on the issue of liability, holding that the Proxy Statement violated SEC Rule 14a-9, and remanded the action for further proceedings (A1, 30). The Seventh Circuit expressly rejected this Court's clear expression in *Mills* that omissions in a proxy statement are material only if they have a "significant propensity" to affect the voting process. Instead the panel adopted and applied a much broader test comprehending as material any facts which may be important for "some few stockholders" regardless of their propensity to affect the voting process (A11-12). It made "relevancy alone the critical test of materiality" and stated that even facts which "may be relevant for some but not for others" are material (A9).

The Seventh Circuit recognized that its test will require many facts to be stated which would not come within the scope of what it referred to as the "stricter 'significant propensity' test" relied on by the district court (A9). Applying its test, the Seventh Circuit granted partial summary judgment, holding that certain omissions, all of which were found not to have been material as a matter of law by the district court, were so important that "reasonable minds could not differ on the question of materiality."

The Seventh Circuit adopted its new "might" test on the basis of its singular and narrowly focused reliance on this Court's statement in *Mills* that the determination of a materiality of misstatement or omission "embodies a conclusion that the defect was of such a character that it might have been considered important by a reasonable shareholder who was in the process of

deciding how to vote." This quoted language immediately precedes this Court's clarifying statement that "[t]his requirement that the defect have a significant *propensity* to affect the voting process is found in the express terms of Rule 14a-9 . . . ." 396 U. S. at 384. The Seventh Circuit, in adopting its "might" test, repeatedly contrasted its approach with the contrary interpretation given to *Mills* by Judge Friendly in the Second Circuit's decision in *Gerstle* v. *Gamble-Skogmo, Inc.*, 478 F. 2d 1281, 1302 (2d Cir. 1973).

REASONS WHY WRIT SHOULD BE GRANTED.

A. The Proper Test of Materiality Is an Important Question of Federal Securities Law on Which a Split of Authority Exists Among the Courts of Appeals and Which Should Be Resolved by This Court.

A uniform and workable definition of "materiality" under the federal securities laws is essential to the fair administration of the shareholder voting process in publicly held companies, as well as SEC Rule 10b-5 and the rules governing registration statements, periodic reports, and tender offers. The materiality test necessarily affects each and every proxy statement pertaining to a corporation whose securities are registered under the 1934 Act. Such corporations represent the greater portion of wealth of United States businesses and the rules applicable to them affect the rights of millions of investors. A judicial determination that a proxy statement omission or misstatement was material often results in serious consequences for the publicly held company and its numerous shareholders. The test of materiality is likewise critically important in registration statements, tender offers and the annual and interim reports of public corporations.

Most of the Courts of Appeals have understood and applied this Court's statement in *Mills* as limiting materiality to matters which have a "significant propensity to affect the voting proc-

ess." Some courts refer to the "significant propensity" test as the "would" test, distinguishing matters that "would" be important to shareholders in deciding how to vote from those that "might" be of importance. The Second Circuit in *Gerstle* v. *Gamble-Skogmo, Inc.*, 478 F. 2d 1281 (2d Cir. 1973) and the Fifth Circuit in *Smallwood* v. *Pearl Brewing Company*, 489 F. 2d 579 (5th Cir. 1974), *cert. denied*, 419 U. S. 873 (1974), both of which involved application of the proxy rules, adopted the "significant propensity" or "would" test and expressly rejected the "might" test adopted by the Seventh Circuit.

In *Smallwood*, the Fifth Circuit said that there was no evidence in *Mills* of any desire by this Court "to relax the standard of materiality to a mere possibility of influence upon a reasonable investor, a standard implied by the word 'might'." On the contrary, the *Smallwood* opinion points out that this Court in *Mills* had emphasized that "the test of materiality required 'a significant *propensity* to affect the voting process'." 489 F. 2d at 604. Similarly, in *Gerstle*, Judge Friendly rejected the word "might" as being "too suggestive of mere possibility, however unlikely" and called for a "realistic standard of materiality." 478 F. 2d at 1302. By contrast, the Seventh Circuit in this action adopted a "might" test and rejected any inquiry as to the propensity of the omitted fact to affect the voting process.

Other Courts of Appeals have adopted the "would" test rather than the Seventh Circuit's "might" test in the related area of liability under Section 10(b) of the 1934 Act and Rule 10b-5. *Titan Group, Inc.* v. *Faggen*, CCH Fed. Sec. L. Rep. ¶ 95,042 (2d Cir. April 1, 1975); *Robinson* v. *Cupples Container Co.*, CCH Fed. Sec. L. Rep. ¶ 95,054 (9th Cir. March 25, 1975); *Marx* v. *Computer Sciences Corp.*, 507 F. 2d 485 (9th Cir. 1974); *Gordon* v. *Burr*, 506 F. 2d 1080 (2d Cir. 1974); *Harnett* v. *Ryan Homes, Inc.*, 496 F. 2d 832 (3d Cir. 1974); *Vohs* v. *Dickson*, 495 F. 2d 607 (5th Cir. 1974); *Rochez Bros., Inc.* v. *Rhoades*, 491 F. 2d 402 (3d Cir. 1974); *Arber* v. *Essex Wire Corp.*, 490 F. 2d

414 (6th Cir. 1974), *cert. denied*, 419 U. S. 830 (1974); *John R. Lewis Inc.* v. *Newman*, 446 F. 2d 800 (5th Cir. 1971); *Herpich* v. *Wallace*, 430 F. 2d 792 (5th Cir. 1970).

The "would" test has also been adopted in determining liability for defective tender offers under Section 14(e) of the 1934 Act. *Chris-Craft Industries, Inc.* v. *Piper Aircraft Corp.*, 480 F. 2d 341 (2d Cir. 1973), *cert. denied*, 414 U. S. 910 (1973); *Gulf & Western Industries, Inc. v. Great A. & P. Tea Company, Inc.*, 476 F. 2d 687 (2d Cir. 1973); *Electronic Specialty Co.* v. *International Controls Corp.*, 409 F. 2d 937 (2d Cir. 1969). It has also been adopted under Section 12(2) of the Securities Act of 1933. *Johns Hopkins University* v. *Hutton*, 422 F. 2d 1124 (4th Cir. 1970).

The test of materiality used by the Courts of Appeals which follow *Mills* is consistent with SEC's definition of the term "material" in Rule 1-02 in Regulation S-X, namely:

> "*Material.* The term 'material,' when used to qualify a requirement for the furnishing of information as to any subject, limits the information required to those matters about which an average prudent investor ought reasonably to be informed." 17 C.F.R. § 210.1-02(m)*

The Seventh Circuit, in rejecting significant propensity and "would" and in adopting "might", realized that different conclusions on materiality would be reached depending upon which test is used (A9).

The distinction between the "significant propensity" test laid down in *Mills* and followed by most circuits and the Seventh Circuit's "might" test is fundamental. The "significant propensity" test is designed to limit the concept of materiality to information which objectively relates in some significant manner or basic respect to the issue presented to the shareholder. The

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* In an amicus brief which the SEC filed in the Seventh Circuit, it did not urge that the "significant propensity" test applied by the district court should be modified but focused its arguments only on the materiality of the claimed omissions under that test.

SEC's rule expressly limits materiality on the basis of a similar objective standard of significance. In contrast, the Seventh Circuit's test, by its emphasis on relevance and on subjective importance to "some few shareholders", effectively removes the intended limiting effect of materiality and makes most relevant facts material and subject to the SEC's disclosure requirements.

The lack of a uniformly recognized test of materiality conflicts with the federally mandated duty of public corporations to prepare and issue proxy statements to shareholders on a nationwide basis. This Court's enunciation of a uniform standard would eliminate the current problem where the choice of forum can determine whether the proxy material of a national corporation is actionable because of material omissions.

This case clearly presents an appropriate vehicle for the Court to enunciate such a uniform standard of materiality. In many cases misstatements or omissions may be so clearly material that there is no need nor occasion to focus on the standard of materiality. In this case, however, the outcome turns on the test applied. This is evidenced by Judge McLaren's denial of summary judgment under the "significant propensity" test and his reversal by the Seventh Circuit under its new test which, as it recognized, encompassed many facts not covered by the "significant propensity" test.

An authoritative ruling by this Court on this important issue of "materiality" is needed not only because the Seventh Circuit misread *Mills*, but also because even those circuits which have followed *Mills* have indicated that they do not regard *Mills* as constituting a "determination of the proper test of materiality." See *Gerstle* v. *Gamble-Skogmo, Inc.*, 478 F. 2d at 1301. In *Mills* the Court specifically dealt only with the issue of causation and did not review the holding of the lower court that the proxy statement there was misleading in material respects. 396 U. S. at 381, n. 4.

B. The Seventh Circuit's Novel Test of Materiality Imposes an Unworkable Burden and Is Unnecessary to Assure Adequate and Fair Disclosure to Investors.

The Seventh Circuit now requires proxy statement authors to include everything relevant which *might* be important to a reasonable shareholder in the process of deciding how to vote, rejecting *any* inquiry into whether or not the omission would have any effect on the shareholder vote.

The appropriateness of any standard of materiality under SEC Rule 14a-9 must be placed in its proper context. Over a forty-year period the SEC has issued and revised its rules and regulations embodied in Schedule 14A, 17 C. F. R. § 240.14a-101, requiring many specific items of disclosure in proxy statements. The omissions complained of in the instant case are not in violation of *any* item of disclosure specified in Schedule 14A. They are violations, if at all, of Rule 14a-9(a)*, a general catch-all provision which requires disclosure of certain additional material matters.

The Seventh Circuit would require submission to shareholders of voluminous relevant information which "might" be of importance to some few shareholders in the process of deciding how to vote. This would impose an unfair burden and could not serve as a workable guide for measuring what is required to be included in a proxy statement. Required matters should be confined to what is needed reasonably to inform investors. The Seventh Circuit's novel test plainly conflicts with SEC's definition of "material" in Rule 1-02 which applies to the four basic securities laws the Commission administers. The SEC's defini-

* In pertinent part, Rule 14a-9(a) provides: "No solicitation subject to this regulation shall be made by means of any proxy statement . . . containing any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading. . . ." (A49)

tion expressly "limits the information required to those matters about which an average prudent investor ought reasonably to be informed."

The novel test of materiality adopted by the Seventh Circuit, emphasizing as it does "relevance for some investors" rather than a "significant propensity to affect the voting process" (A9), is clearly impractical and imposes an intolerable burden upon all public companies. Proxy statements often deal with complex transactions such as mergers and acquisitions which may involve literally thousands of relevant facts which might arguably be of interest to some shareholders. It is impossible to include in proxy statements, other SEC filings and published data such as annual and interim reports to shareholders, all of the information which *some* few shareholders might regard as relevant.

For example, in describing the business of a company to be acquired, an attempt to include all facts someone might regard as relevant would require scores of pages and yet would almost certainly fail to satisfy the Seventh Circuit's test. Those who prepare proxy statements must make many judgments distinguishing between those facts which should be disclosed to shareholders to highlight the basic considerations touching a transaction submitted to them for their approval and those less important items of relevant data which can and should be left out as being redundant, cumulative or mere details. Indeed, it is this differentiation which underlies the requirement of adequate and fair disclosure and is at the very heart of the "significant propensity" test.

The Seventh Circuit's test would compel the accumulation and recitation in a proxy statement of all facts, regardless of objective significance, which might be important to some shareholders. This is plainly at odds with the disclosure duties spelled out in the federal securities laws.

Moreover, since it is impossible to include in a proxy statement a complete statement of all facts which might be relevant to

some shareholder, such approach would—in effect—give shareholders an option to force a rescission of any transaction if, upon hindsight, the transaction appears unfavorable. This would open the federal courthouse to a flood of additional lawsuits by disgruntled stockholders latching on to the omission of what is relevant instead of what had a significant propensity to affect the voting process.

The Congress intended to assure adequate and fair disclosure, not to impose an unrealistic burden of accumulating all that is relevant, failing which stockholders would have the option to rescind a transaction or obtain damages. Judge Friendly described the problem and its solution in a case involving the disclosure requirements relating to tender offers in *Electronic Specialty Co.* v. *International Controls Corp.*, 409 F. 2d 937, 948 (2d Cir. 1969):

> "Probably there will no more be a perfect tender offer than a perfect trial. Congress intended to assure basic honesty and fair dealing, not to impose an unrealistic requirement of laboratory conditions. . . ."

Judge McLaren appreciated this distinction, observing that

> "It has been recognized that '[i]t is easy to find small errors or trivial omission in any proxy statement'. . . ." (A38).

A workable standard should include an inquiry into whether the omission is likely to affect the voting process. This inquiry need not involve the kind of factual demonstration of causation this Court sought to avoid in *Mills* v. *Electric Auto-Lite Co.*, 396 U. S. 375 (1970) and *Affiliated Ute Citizens* v. *United States*, 406 U. S. 128 (1972), but should be based on the objective reasonable man standard. Propensity to affect the voting process gives a practical dimension to materiality—that the omission or misstatement is likely to alter the outcome of shareholder voting.

C. The Seventh Circuit Misused Summary Judgment, and Hence Improperly Foreclosed TSC and National from a Trial as to the Issue of the Materiality of the Complained of Omissions, by Finding Such Omissions to Be Material as a Matter of Law.

Plaintiff's motion before Judge McLaren was for partial summary judgment against TSC and National on the issue of liability alone. Necessarily, the motion was based on the premise that certain omissions from the Proxy Statement were "material" as a matter of law and that consequently the Proxy Statement was fatally defective under the disclosure requirements of the 1934 Act and the proxy rules issued thereunder. Under Rule 56(c) of the Federal Rules of Civil Procedure, Plaintiff had the burden of showing that there was no genuine issue as to any material fact and that Plaintiff was entitled to judgment on the issue of liability as a matter of law.

Ordinarily materiality of an omission is a question of fact, to be determined by the trier of fact. Only when reasonable men may not differ on the issue of materiality can it be determined as a matter of law. *Johns Hopkins University* v. *Hutton*, 422 F. 2d 1124, 1129 (4th Cir. 1970); *Rogen* v. *Ilikon Corp.*, 361 F. 2d 260, 266 (1st Cir. 1966). If different permissible inferences may be drawn from the underlying facts in the summary judgment record, no summary judgment may be granted. *United States* v. *Diebold, Inc.*, 369 U. S. 654, 655 (1962).

After considering the entire summary judgment record, including uncontroverted opposing affidavits filed by TSC and National as evidence that National lacked the power to direct or cause the direction of TSC's management, Judge McLaren concluded that Plaintiff had failed to establish the absence of a genuine question of fact as to the material issue of whether National was in control of TSC (A34).

The Seventh Circuit agreed that there was a bona fide dispute on the issue of National's alleged control of TSC (A6) and

also agreed with Judge McLaren's holding that Plaintiff must establish undisputed facts sufficient to show that one or more of the items omitted from the Proxy Statement was material as a matter of law in order to render the Proxy Statement fatally defective under Rule 14a-9. The panel also concurred with the district judge that to establish materiality as a matter of law, it must be shown that reasonable minds could not differ on the question of materiality (A7).

However, the Seventh Circuit then proceeded to announce its own lesser test of materiality, saying that relevancy is the only real criterion and it would be sufficient for the omitted facts to be of importance to some few stockholders (A8-9). Thus, the panel set itself apart from this Court's opinion in *Mills*, as well as from Judge McLaren who concluded that the omissions Plaintiff complained of were not material as a matter of law since reasonable men could differ on whether "these facts were so obviously important" as to "have a significant propensity to affect the voting process" (A38).

In applying its new test the Seventh Circuit granted summary judgment, treating as material omissions from the Proxy Statement references to prior SEC filings in which TSC and National had stated the legal conclusion that National "may be a parent of TSC," and the fact that National's president and executive vice president, who had been specifically named at page 6 of the Proxy Statement as being among National's nominees on the TSC Board, were respectively the chairman of the TSC Board and the chairman of the Board's executive committee. In the light of the prominent and accurate disclosures actually made in Proxy Statement those complained of omissions could not have had any effect on the voting process. At most such omissions posed issues for the trier of fact.

The other omissions which the Court of Appeals found material as a matter of law were a letter opinion of TSC's investment banker, Hornblower & Weeks-Hemphill, Noyes, regarding

the value of National's warrants (A43-44) and the open market purchases of National's common stock by Madison Fund, a diversified investment company which had purchased both National debentures and National common stock at various times during 1968 and 1969 (A40-42). Due to the disputed issues of fact and the incomplete record, the significance of these omissions was not ripe for determination on summary judgment and no proper finding as to their propensity to affect the voting process could have been made (A38, 43-44). Accordingly, on this record proper application of the *Mills* test would not result in a finding that these omissions were material as a matter of law.

The Seventh Circuit plainly misused summary judgment procedure in holding that all these omissions were material as a matter of law. This was contrary to Judge McLaren's decision that a trial was necessary after making his detailed fact and law analysis. To reach such conclusions the court below had to espouse its own novel test of materiality under the securities laws in which it employs a "might have" test and treats relevancy of the omitted factual material as the only criterion of materiality.

Obviously, by placing the threshold of materiality so low as to require only that the omitted fact be relevant and deemed important by some few shareholders (A9), many truly redundant, cumulative and *de minimis* factual matters can be transformed into "material" facts. This novel test was the vehicle the Seventh Circuit used in abusing summary judgment and thereby unfairly foreclosing TSC and National from a trial on the issue of materiality of the complained of omissions.

CONCLUSION.

For the foregoing reasons the Court should grant this petition for a writ of certiorari.

Respectfully Submitted,

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May 23, 1975.

EXHIBIT TO PETITION

Pages 6-7 of Proxy Statement
(Vol. III, Part 1, Ex. A to Complaint)

PROPOSED AGREEMENT TO SELL TSC'S ASSETS TO NATIONAL AND LIQUIDATION AND DISSOLUTION OF TSC

Boards of Directors Approval

The Boards of Directors of National and TSC have approved the Agreement and believe that the transactions contemplated thereby are in the best interests of the shareholders of both corporations, who will benefit through the diversified activities of the surviving corporation. In reaching their decision the Boards of Directors of each corporation considered not only recent market prices of the securities of the two corporations, but also the preferred dividend to be paid to the TSC stockholders, the businesses and financial conditions of both corporations and various other factors.

At the request of TSC, the investment banking firm of Hornblower & Weeks-Hemphill, Noyes rendered a favorable opinion as to the fairness to the stockholders of TSC of the terms, set forth below, for the exchange of the shares of TSC for securities of National. The TSC Board considered this opinion in approving the sale. In such opinion, said firm considered, among other things, the current market prices of the securities of both corporations, the high redemption price of the National Series B Preferred Stock, the dividend and debt service requirements of both corporations, the substantial premium over current market values represented by the securities being offered to TSC stockholders, and the increased dividend income.

Hornblower & Weeks-Hemphill, Noyes did not receive a fee for its services. Mr. Blancke Noyes, a partner in said firm is, and has been since 1968, a Director of TSC. Mr. Noyes is the owner of 500 shares of TSC Series 1 Preferred Stock, 1,000 shares of TSC Common Stock and 100 shares of National Common Stock. Mr. Noyes' wife also beneficially owns 1,000 shares of TSC Common Stock. In March 1969, Hornblower & Weeks-Hemphill, Noyes acted as the principal underwriter in the public offering of 195,000 shares of TSC Common Stock.

National's Equity Interest in TSC

As noted above, National owns 519,733 shares (approximately 28%) of the presently outstanding shares of TSC Common Stock and 439,675 shares (approximately 46%) of the presently outstanding shares of TSC Series 1 Preferred Stock.

On February 7, 1969, National purchased from Mr. Charles E. Schmidt (then a director of TSC), his wife, his two sons, and a charitable foundation of which Mr. Schmidt was a trustee, 434,682 shares of Common Stock of TSC for cash and notes of National, totalling $13,040,460 ($30.00 per share) and 439,675 shares of TSC Series 1 Preferred Stock for cash and notes of National totalling $9,892,687.50 ($22.50 per share), the total of $22,933,147.50 being payable one-fourth in cash and three-fourths in 5% Notes of National payable in six annual installments. In addition, National transferred Warrants to said sellers granting them the right to purchase a total of 125,000 shares of Common Stock of National during the year commencing February 7, 1974 at $24 a share, subject to certain anti-dilution provisions.

Pursuant to an Agreement dated October 14, 1969, National purchased from Mr. Orville E. Peterson, a director of TSC and President of Big Bear, Inc., a subsidiary of TSC, his wife, brother and their immediate families 85,051 shares of Common Stock of TSC for cash and notes of National totalling $1,190,714 ($14.00 per share), being payable one-tenth in cash and the balance in 5% notes of National payable in six annual installments beginning on January 2, 1970.

National's Nominees on TSC's Board

At the request of National, Mr. Stanley R. Yarmuth, President and a Director of National, Mr. Charles F. Simonelli, Executive Vice President and a Director of National, Mr. Allan B. Solomon, Vice President of National, and Mr. Hyman Ullner, Cincinnati, Ohio, were elected Directors of TSC at the Annual Meeting of Stockholders of TSC held on March 31, 1969. At a subsequent Directors' Meeting, Mr. Jack Segell, President of G*E*S Stores, Incorporated, a subsidiary of National, was

elected a Director of TSC. The remaining directors of TSC, namely Mr. Blancke Noyes, Mr. Orville E. Peterson, Mr. Richard H. Schaefer, President of TSC, Mr. Max J. DeForest, Vice President of TSC's Tractor Division, and Mr. Carl W. Sharfman, Vice President of TSC, are not affiliated with National.

Proposed Transaction

Under the applicable provisions of the Agreement, on the Closing Date (therein defined) TSC will sell to Transferee substantially all its assets, properties and business. In consideration therefor, Transferee will assume substantially all of the liabilities of TSC, and National will issue to TSC sufficient National securities so that each outstanding share of TSC Series 1 Preferred Stock will be exchanged upon liquidation of TSC for .6 share of National Series B Preferred Stock and one National Warrant, and each share of TSC Common Stock will be exchanged for .5 share of National Series B Preferred Stock and one and one-half National Warrants.

Each full share of National Series B Preferred Stock will be entitled to a cumulative quarterly dividend at the annual rate of $1.25 a share, accruing from the last dividend payment date, will be convertible, on and after the date of issuance, into .75 share of National Common Stock (subject to adjustment), will be entitled to one vote, may be redeemed by National at any time after the Closing Date at $26 per share, and will be entitled to a preference on liquidation of National.

Each National Warrant will entitle the holder to purchase one share of National Common Stock at a price of $21.40 per share (subject to adjustment) until October 31, 1978. For a further description of the terms and provisions of the National Capital Stock, the National Series B Preferred Stock and the National Warrant, see "Description of Capital Stock" and "Description of Warrants of National" herein and Appendices 1, 2 and 3 to the Agreement enclosed herewith as Exhibit B.

The National Series B Preferred Stock and National Warrants received by National as a stockholder of TSC will, when received by National in the liquidation and dissolution of TSC, be held in National's treasury until cancelled and retired or reissued.

The Agreement also provides, among other things, that:

(a) After the Closing TSC will, in accordance with the Plan of Complete Liquidation, promptly distribute to its stockholders in liquidation, the shares of National Series B Preferred Stock and National Warrants issued by National to TSC and will thereafter dissolve.

(b) TSC's name shall be changed to "TS Liquidating Company".

(c) National will assume the obligations of TSC under its employee stock options outstanding on the Closing Date. Each option to purchase shares of TSC will become options to purchase the maximum number of shares of Common Stock of National at the lowest price per share as is permitted by the Internal Revenue Code without such assumption being considered a modification thereunder.

(d) From the date of the Agreement to the Closing Date, TSC will not, without the prior written consent of National, declare or pay any dividend in excess of the regular quarterly dividend of $.175 per share on its Series 1 Preferred Stock or declare or pay any dividend on its common stock.

If approved at the shareholders' meetings, and unless abandoned or terminated as provided in the Agreement (see "Rights of Termination" below), the sale of assets will be consummated as soon as practicable after the shareholders' meetings.

Other Provisions of Acquisition Agreement

There is set forth below a summary of certain other provisions of the Agreement. The preceding discussion of the Agreement and the following summary does not purport to be complete, and are subject in all respects to the provisions of the Agreement, a copy of which is enclosed herewith as Exhibit B.

Fractional Interests. No fractional shares of National Series B Preferred Stock or fractional interests in National Warrants (and no scrip certificates for any of the foregoing) will be issued.

APPENDIX A.

IN THE UNITED STATES COURT OF APPEALS,
For the Seventh Circuit.

No. 73-1922

NORTHWAY, INC., a Delaware corporation,

Plaintiff-Appellant,

vs.

TSC INDUSTRIES, INC., a Delaware corporation, NATIONAL INDUSTRIES, INC., a Kentucky corporation, and TSC INDUSTRIES, INC. (formerly named NII, INC., and being the successor to the business, assets and corporate name of the said TSC INDUSTRIES, INC.) a Delaware corporation, CHARLES E. SCHMIDT, DOROTHY F. SCHMIDT, RICHARD L. SCHMIDT, CHARLES E. SCHMIDT, JR., CHARLES E. SCHMIDT and DOROTHY F. SCHMIDT FAMILY FOUNDATION,

Defendants-Appellees.

Appeal from the United States District Court for the Northern District of Illinois, Eastern Division—No. 69 C 2513.

RICHARD W. MCLAREN, *Judge.*

Argued September 12, 1974—Decided March 5, 1975

Before SWYGERT, CUMMINGS and PELL, *Circuit Judges.*

SWYGERT, *Circuit Judge.* This appeal concerns violations of Rules 14a-3 and 14a-9 issued by the Securities Exchange Commission pursuant to section 14(a) of the Securities Exchange Act of 1934, 15 U. S. C. § 78n(a). This section makes it

unlawful for any person to solicit by mail or other means of interstate commerce proxies of a registered security in violation of rules promulgated by the Commission pursuant to the statute. The appeal also concerns alleged violations of section 78j(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder.

Plaintiff Northway, Inc. brought this action against defendants National Industries, Inc. and TSC Industries, Inc. for alleged violations of section 14a in connection with the acquisition of TSC by National in a stock-for-stock purchase. Northway alleges that these corporate defendants issued a joint proxy statement in connection with a take-over, which statement was incomplete and materially misleading. In addition, Northway brought suit against Charles E. Schmidt and various members of his family alleging that these defendants also violated the Securities and Exchange Act by selling their controlling interest in TSC without adequately protecting the interests of its other shareholders. The Schmidt defendants were also charged with aiding and abetting the corporate defendants. Northway appeals from orders of the district court denying its motion for summary judgment on the issue of liability of the corporate defendants, denying its similar motion as to the Schmidt defendants, and granting a cross-motion for summary judgment filed by the Schmidt defendants. Appeal is taken by leave pursuant to 28 U. S. C. § 1292(b), the district court and this Court having found that the disposition of these motions involves controlling and important questions of law as to which there is substantial ground for difference of opinion, and that immediate appeal may materially advance the ultimate termination of this litigation. We affirm the granting of summary judgment for the Schmidt defendants, but reverse the denial of summary judgment as to the liability of the corporate defendants.

I

Plaintiff Northway is a Delaware corporation doing business in Illinois, where it maintains its principal place of business. In January and February of 1969 Northway owned 200 shares of common stock in TSC Industries, also a Delaware corporation. Northway continued to own the TSC stock throughout the period of the transactions challenged in this lawsuit.

As of January 16, 1969 Charles E. Schmidt, Sr. and various members of his family owned approximately one third of the outstanding voting shares in TSC.[1] In addition, Mr. Schmidt and his son, Charles E. Schmidt, Jr., were members of the TSC board of directors. On that day, Mr. Schmidt was approached by representatives of National Industries, Inc., a Kentucky corporation, who inquired into the possibility of acquiring all of the Schmidt family interest in TSC.[2] After reviewing his own financial position and after an evaluation of National Industries and its key personnel, Mr. Schmidt determined that he would move ahead with the sale. On January 30, 1969 a stock purchase agreement was signed. Under the agreement, the Schmidt defendants were to receive substantially the then market value for their TSC securities. Payment was to be in cash and National's 5% notes payable in six annual installments.[3] Immediately after signing the agreement Mr. Schmidt

1. Mr. Charles E. Schmidt, Sr. owned 411,703 shares of TSC common stock and 338,974 shares of its preferred stock. A residue of 16,137 common shares and 100,601 preferred shares was owned in various proportions by Dorothy F. Schmidt, Richard L. Schmidt, Charles E. Schmidt, Jr. and the Charles E. Schmidt and Dorothy F. Schmidt Family Foundation.

2. The meeting with the National representatives had been arranged by Mr. Schmidt's neighbor, Mr. Frank Cryan, without Mr. Schmidt's knowledge or prior consent. Mr. Schmidt was informed that the meeting had been arranged on the morning of the 16th.

3. National agreed to pay $30 per share for the common stock and $22.50 per share for the preferred. A cash payment of 25% was agreed to, with the balance payable in five annual installments

(Footnote continued on next page)

tendered his resignation from the board of directors of TSC. Mr. Schmidt's son, Charles E. Schmidt, Jr., tendered his resignation from the TSC board of directors on February 7, 1969, the date of closing of the stock transfer. The Schmidt defendants had no further contact with TSC or National after February 7, 1969.

Shortly after the acquisition of the Schmidt interests, on March 31, 1969, four National nominees were elected to the ten-man board of directors of TSC.[4] On that same day, Stanley R. Yarmuth, president and chief executive officer of National, became the chairman of the TSC board of directors and Charles F. Simonelli, executive vice president of National, became chairman of the TSC executive committee.

On October 16, 1969, a proposal to liquidate and dissolve TSC and to sell all its assets to National was considered at a meeting of the TSC board of directors. Under the proposal National was to acquire all TSC assets in return for National securities. Eight members of the TSC board of directors attended this meeting.[5] The proposition received the affirmative votes of four non-National directors. The three National nominees on the TSC board attending the meeting abstained from

of 10% of the *total* price and a sixth installment of the remaining 25% in the sixth year. In consideration of the low interest rate of 5% on the deferred notes, National gave the Schmidts 125,000 warrants for the purchase of National common stock at $24 per share exercisable during the one year period between February 7, 1974 and February 7, 1975.

4. The four National nominees were Mr. Stanley R. Yarmuth, president and a director of National, Mr. Charles F. Simonelli, executive vice-president and a director of National, Mr. Allan B. Solomon, vice-president of National, and Mr. Hyman Ullner, of Cincinnati, Ohio. Subsequently, Mr. Jack Segell, President of G*E*S Stores, Inc., a subsidiary of National, was elected to the TSC board.

5. Attending were National nominees Messrs. Yarmuth, Solomon and Segell, and non-National board members Max J. DeForest, Blanke Noyes, Orville E. Peterson, Richard H. Schaefer and Carl W. Scharfman.

voting on the advice of their attorneys. One non-National director also abstained.

On November 12, 1969, TSC and National issued a joint proxy statement to the shareholders of TSC concerning the proposed liquidation and sale. The statement urged TSC shareholders to approve the transaction. Sufficient proxies were received and voted in favor of the proposal to cause it to be approved. TSC was placed in liquidation and dissolution and notices were sent to all TSC stockholders advising them that they were required to exchange their TSC shares for National securities. Shares were exchanged and the transaction completed.

II

Corporate defendants National Industries, Inc., and TSC, Inc. are charged with violations of § 14(a) of the Securities Exchange Act of 1934, 15 U. S. C. § 78n(a),[6] and Rules 14a-3 and 14a-9 thereunder.[7] The 14a-3 claim is based on the failure of the corporate defendants to include in the joint proxy statement the conclusion that a change in control of TSC had taken place as a result of the transfer of the Schmidt interests in TSC to National.[8] The 14a-9 claim is based on the

6. § 14(a) provides:

> It shall be unlawful for any person, by the use of the mails or by any means or instrumentality of interstate commerce or of any facility of a national securities exchange or otherwise, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors, to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security (other than an exempted security) registered pursuant to section 781 of this title.

7. 17 C. F. R. § 240.14a-3; 17 C. F. R. § 240.14a-9.

8. Rule 14a-3(a) provides that:

> No solicitation subject to this regulation shall be made unless each person solicited is concurrently furnished or has previously been furnished with a written proxy statement containing the information specified in Schedule 14A.

(Footnote continued on next page)

failure of the corporate defendants to include certain material information in the joint proxy statement concerning the degree of potential influence of defendant National in the management of TSC, the favorability of the terms of the National acquisition proposal to the TSC shareholders, and the formal approval by the TSC board of directors of the resolution of liquidation and dissolution.[9]

We agree with the district court that the issue of control is a factual issue presently in dispute and that summary judgment as to the Rule 14a-3 claim would have been inappropriate. The essence of the 14a-3 claim is that the proxy statement failed to disclose, in accordance with Schedule 14A, that a change of control of TSC had taken place during the preceding fiscal year. Each side has presented exhibits and affidavits tending to support their conflicting views on the control issue. The trial court properly denied Northway's motion in the face of this bona fide dispute.

Plaintiff's Rule 14a-9 motion for summary judgment is quite different from the 14a-3 motion. The central question under Rule 14a-9 is whether, considering all of the circum-

Schedule 14A, Item 5, requires:

(e) If to the knowledge of the persons on whose behalf the solicitation is made a change in control of the issuer has occurred since the beginning of the last fiscal year, state the name of the person or persons who acquired such control, the basis of such control, the date and a description of the transaction or transactions in which control was acquired and the percentage of voting securities of the issuer now owned by such person or persons.

9. Rule 14a-9 provides:

(a) No solicitation subject to this regulation shall be made by means of any proxy statement, notice of meetings or other communication, written or oral, containing any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading or necessary to correct any statement in any earlier communication with respect to the solicitation of a proxy for the same meeting or subject matter which has become false or misleading.

stances which existed at the time the joint proxy statement was issued, the proxy statement was false or misleading in its presentation of a material fact or in its failure to include such a fact. Northway contends that the statement was misleading because of five omissions of fact, all of which it says were material. To prevail on the 14a-9 issue Northway must establish undisputed facts sufficient to show that one or more of the omitted items is material as a matter of law. To do this, it must demonstrate that reasonable minds could not differ on the question of materiality. *Johns Hopkins University* v. *Hutton*, 422 F. 2d 1124, 1129 (4th Cir. 1970); *Beatty* v. *Bright*, 318 F. Supp. 169, 173 (S. D. Iowa 1970); *Berman* v. *Thompson*, 312 F. Supp. 1031, 1034 (N. D. Ill. 1970).

In *Mills* v. *Electric Autolite Co.*, 396 U. S. 375, 90 S. Ct. 616, 24 L. Ed. 2d 593 (1960), the Supreme Court addressed itself to the elements of a cause of action brought under Rule 14a-9. The Court held that once materiality is established, specific proof of causation is unnecessary providing it is shown that the proxy statement itself was an essential link in the transaction. The Court thus recognized that the concept of materiality is itself defined in terms of potential causative effects.[10]

10. The pertinent language is:

Where the misstatement or omission in a proxy statement has been shown to be "material," as it was found to be here, that determination itself indubitably embodies a conclusion that the defect was of such a character that it might have been considered important by a reasonable shareholder who was in the process of deciding how to vote. This requirement that the defect have a significant *propensity* to affect the voting process is found in the express terms of Rule 14a-9, and it adequately serves the purpose of ensuring that a cause of action cannot be established by proof of a defect so trivial, or so unrelated to the transaction for which approval is sought, that correction of the defect or imposition of liability would not further the interests protected by § 14(a).

There is no need to supplement this requirement, as did the Court of Appeals, with a requirement of proof of whether the defect actually had a decisive effect on the voting. Where there

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Since *Mills*, some uncertainty has developed as to which language in that opinion represents the proper test to apply in determining the materiality of an omitted fact. Different results could flow from a test requiring only that the omitted fact "might have been considered important by a reasonable shareholder who was in the process of deciding how to vote" than would flow from a test requiring that the fact have "a significant *propensity* to effect the voting process."[11] On a motion for summary judgment, the "might have" test would ask whether a reasonable mind could conclude that the omitted fact is so irrelevant that it would never reasonably be considered important. The "significant propensity" test would ask whether a reasonable mind could conclude that the fact is less than significant in its potential to affect the voting process. Many facts which are revelant within the first test could reasonably be said to have less than a significant propensity to affect the voting process taken as a whole, even though for some few stockholders these same facts could be determinative.

has been a finding of materiality, a shareholder has made a sufficient showing of casual [sic.] relationship between the violation and the injury for which he seeks redress if, as here, he proves that the proxy solicitation itself, rather than the particular defect in the solicitation materials, was an essential link in the accomplishment of the transaction. This objective test will avoid the impracticalities of determining how many votes were affected, and, by resolving doubts in favor of those the statute is designed to protect, will effectuate the congressional policy of ensuring that the shareholders are able to make an informed choice when they are consulted on corporate transactions. 396 U. S. at 384-85.

11. The district judge twice stated the burden of plaintiffs in this case in terms of the "might have been considered important" test:

> To establish a violation [of Rule 14a-9], plaintiff must prove . . . (b) that the misstatement or omissions were material in the sense that they "might have been considered important by a reasonable shareholder who was in the process of deciding how to vote." . . .
>
> The pivotal question as to plaintiff's motion for summary judgment on this ground is thus whether certain facts relating to the relationship between TSC and National which were omitted from the joint proxy statement were, as a matter of law, material. To meet its burden, plaintiff must show that the facts withheld were so obviously important to TSC shareholders that reasonable minds could not differ on the question of whether the shareholders might have considered them important. 361 F. Supp. at 111-12.

But in denying plaintiff's motion for summary judgment, he specifically relied on the stricter, "significant propensity" test:

> While the Court believes that the prior claims of control made to the SEC and Yarmuth's and Simonelli's other positions might have been considered important by TSC shareholders, it cannot conclude that these facts were so obviously important that reasonable minds could not differ on the issue; that is, as to whether they would have a significant propensity to affect the voting process. 361 F. Supp. at 114.

We believe the policies which underlie § 14(a) and Rule 14a-9 are best served by a test that includes all facts which a reasonable stockholder might consider important. We are mindful of Judge Friendly's thorough consideration of this question and of the criticism that such a test is "too suggestive of a mere possibility, however unlikely." *Gerstle* v. *Gamble-Skogmo, Inc.*, 478 F. 2d 1281, 1302 (2d Cir. 1973). Yet we think any test which does not require the inclusion of facts which *could* influence a reasonable stockholder would seriously undercut the intended prophylatic effect of these disclosure provisions. Any speculation under such a test is limited by the "reasonable stockholder" language therein and by the overriding purposes of § 14(a),[12] from which any test must take its meaning and to which Justice Harlan specifically referred in *Mills*. This test will not reach "trivial" and "unrelated" facts; neither will it fail to reach facts which may be relevant for some, but not for others.

We are convinced that the test we adopt is supported by the reasoning of the Supreme Court in *Mills* and in *Affiliated Ute Citizens* v. *United States*, 406 U. S. 128, 92 S. Ct. 1456,

12. The Court has said that the 1934 Act and its companion legislative enactments embrace a "fundamental purpose . . . to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry. *Affiliated Ute Citizens* v. *United States*, 406 U. S. 128, 151, 92 S. Ct. 1456, 31 L. Ed. 2d 741 (1972).

31 L. Ed. 2d 741 (1972). These cases held that proof of causation or actual reliance is unnecessary to establish liability under Rules 14a-9 and 10b-5 in connection with a failure to disclose, and that causation is established once it is shown that the facts in question might have been considered important by a reasonable stockholder. It would make little sense to hold that causation is established by a more lenient standard than materiality. In fact any test of materiality which requires a finding of some probability that the omitted fact would affect the voting process necessitates the same difficult proofs the Supreme Court sought to avoid by eliminating the need for independent proof of causation or reliance.[13]

13. While Judge Friendly saw the distinction between "would" and "might" as small, perhaps even "gossamer," *Gerstle, supra,* at 1302, we believe that *Mills* and *Ute* preclude such an analysis. Once the element of probability becomes a part of the materiality test, a mere showing of relevancy of omitted facts is inadequate to establish a violation of 14a-9 or 10b-5. Under a probability test, we cannot see how the plaintiff would prevail without introducing some evidence, direct or indirect, tending to show that the challenged omission had an actual impact in his case. If there is a distinction, in the trial context, between proofs which show that a particular omission would have been relied upon, and those which show that the omission was in fact relied upon, it is so subtle as to have no practical significance. We believe that relevancy alone is the critical test of materiality and that when relevant facts are withheld from a proxy solicitation, materiality is established independent of any proofs of probable reliance or causation.

It is interesting to note that Judge Friendly cites *List* v. *Fashion Park, Inc.*, 340 F. 2d 457, 462 (2d Cir., 1965), *cert. denied,* 382 U. S. 811, 86 S. Ct. 23, 15 L. Ed. 2d 60 (1965) and *SEC* v. *Texas Gulf Sulphur Co.*, 401 F. 2d 833 (2d Cir. 1968), *cert. denied,* sub nom. *Coates* v. *Securities and Exchange Commission,* 394 U. S. 976, 89 S. Ct. 1454, 22 L. Ed. 2d 756 (1969) in support of the probability test. Neither case is absolutely clear on the precise test of materiality. In *List,* although the court quotes the Restatement of Torts § 538(2)(a) to the effect that material facts are those to which "a reasonable man *would* attach importance" (emphasis added), it also quotes with approval this court's holding in *Kohler* v. *Kohler Co.*, 319 F. 2d 634 (7th Cir. 1963) that material facts include those facts "which in reasonable and objective contemplation *might* affect the value of the corporation's stock or securities." *Id.* at 642. In *Texas Gulf Sulphur, both* tests approved in *List* are quoted, and the court further holds that

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Finally, we cannot agree with the argument that the Supreme Court has twice included the "might have" test without specific consideration of the materiality issue itself. See *Gerstle* v. *Gamble-Skogmo, Inc., supra* at 1301-02 and n. 21; *Smallwood* v. *Pearl Brewing Company,* 489 F. 2d 579, 604 (5th Cir. 1974). Had Justice Blackmun intended to leave the definition of materiality open in *Ute,* he could have done so. He chose not to, but instead adopted the essence of the *Mills* test:

> [D]efendants devised a plan and induced the mixed blood holders of UDC stock to dispose of their shares without disclosing to them material facts which could have been expected to influence their decisions to sell. . . .
>
> Under the circumstances of this case, involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of this decision. 406 U. S. at 153-54.

This is entirely consistent with the purposes of disclosure requirements and with the policy of "resolving doubts in favor of those the statute is designed to protect." *Mills* v. *Electric Autolite Co.*, 396 U. S. at 385.

Having concluded that the proper test of materiality is whether the omitted fact is "of such a character that it might have been considered important by a reasonable shareholder

> material facts include not only information disclosing the earnings and distributions of a company but also those facts which affect the probable future of the company and those which *may* affect the desire of investors to buy, sell or hold the company's securities. 401 F. 2d at 849. (emphasis added)

Indeed, Judge Friendly himself used a "mixed" test in *General Time Corp.* v. *Talley Industries, Inc.*, 403 F. 2d 159 (2d Cir. 1968), *cert. denied,* 393 U. S. 1026, 89 S. Ct. 631, 21 L. Ed. 2d 570 (1969):

> The test, we suppose, is whether, taking a properly realistic view, there is a substantial likelihood that the misstatement or omission *may* have led a stockholder to grant a proxy to the solicitor or to withhold one from the other side, whereas in the absence of this he would have taken a contrary course. *Id.* at 162. (emphasis added)

who was in the process of determining how to vote," *Id.* at 384, we consider the five separate facts omitted from the joint proxy statement in this case.

A

Northway's initial charge is that the joint proxy statement failed to disclose two material facts related to the question of National's potential influence over the management of TSC. Specifically, the proxy failed to show that both TSC and National had filed special reports with the Securities Exchange Commission indicating that the transfer of the Schmidt interests had resulted in a change in control of TSC and that National could be deemed the "parent" of TSC as a result of that transfer.[14] The statement also failed to show that at the time

14. In connection with the acquisition of the Schmidt interests by National, both National and TSC filed special reports with the SEC in compliance with the Securities Exchange Act of 1934. National filed a Schedule 13D in compliance with § 13(d) of the Act, 15 U. S. C. § 78m(d). Item four in that schedule requires that if the *purpose of the acquisition is to acquire control* of the business of the issuer, any plans or proposals of the acquiring party to make major changes in that business must be disclosed. In response to that item, National stated in part:

> National has acquired approximately 33% of the outstanding voting shares of TSC, Inc. Accordingly, National may be deemed to be a "parent" of TSC as that item is defined in the Rules and Regulations under the Securities Act of 1933.

TSC filed Forms 10-K and 8-K in compliance with section 15(d) of the Act, 15 U. S. C. § 78o. The Form 10-K, at Item 3(a), contained language identical to that found in National's 13D filing indicating that National could be deemed to be the "parent" of TSC. The Form 8-K, at Item 1, entitled "Changes in Control of Registrant," contained a reference back to the "parent" language in Form 10-K.

The definition of the term "parent" is found at S.E.C. Rule 12b-2(a), (f), (k), 17 C. F. R. § 240.12b-2(a), (f), (k):

> Unless the context otherwise requires, the following terms, when used in the rules contained in this regulation or in Regulation 13A or 15D or in the forms for applications, statements and reports filed pursuant to Section 12, 13 or 15(d) of the Act, shall have the respective meanings indicated in this rule:
>
> (a) *Affiliate.* An "affiliate" of, or a person "affiliated" with, a specified person, is a person that directly, or indirectly through

(Footnote continued on next page)

the TSC board of directors considered the proposed merger transaction and at the time the joint statement was issued, the chairman of the TSC board of directors was Stanley Yarmuth, National's president and chief executive officer, and the chairman of the TSC executive committee was Charles Simonelli, National's executive vice president.

Northway contends that failure to include these facts was misleading since TSC stockholders were relying on the TSC board of directors to negotiate on their behalf for the best possible rate of exchange with National. Because these facts were persuasive indicators that the TSC board was in fact under the control of National, and that National thus "sat on both sides of the table" in setting the terms of the exchange, Northway says these facts were material to a decision whether or not to approve the terms of the transaction as a matter of law. We agree.

While the proxy statement did indicate that five of the ten positions on the TSC board of directors were held by nominees of National and that National held a substantial equity position in TSC amounting to thirty-four percent of outstanding voting securities, this did not render the additional information bearing on National's influence over TSC merely cumulative or trivial. Indeed, there is a vast difference between the picture presented by these facts alone and the picture which would have resulted from the addition of the facts that National nominees occupied the chairmanships of both the board of directors and the executive committee of TSC and that even before the National nominees became TSC board members, both National and TSC

> one or more intermediaries, controls, or is controlled by, or is under common control with, the person specified.
>
> (f) *Control.* The term "control" (including the terms "controlling," "controlled by" and "under common control with") means the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise.
>
> (k) *Parent.* A "parent" of a specified person is an affiliate controlling such person directly, or indirectly through one or more intermediaries.

thought it necessary to inform the Securities Exchange Commission that National could be deemed to be in control of TSC.[15] The picture presented in the joint proxy statement may well have indicated to "those aware of the corporate mechanism," *Mills* v. *Electric Autolite Company*, 403 F. 2d 429, 433 (7th Cir. 1968), rev'd on other grounds, 396 U. S. 375, 90 S. Ct. 616, 24 L. Ed. 2d 593 (1970), that National was in a position to exert considerable influence over TSC, but all stockholders, unsophisticated and sophisticated alike, were entitled to the full picture: that a substantial likelihood existed that National's influence in fact amounted to control.

We hold that failure to disclose the prior filings with the Securities Exchange Commission and the failure to disclose the crucial positions held by National nominees Yarmuth and Simonelli on the TSC board of directors were materially misleading within the meaning of § 14(a) of the Securities Exchange Act of 1934 and Rule 14a-9 thereunder as a matter of law. The order of the district court denying summary judgment against the corporate defendants on the issue of liability must therefore be reversed on this ground alone.

B

Northway further contends that the proxy statement was materially misleading in its failure to disclose two sets of facts relating to the favorability of the terms of the proposed merger transaction to TSC shareholders. The first omission involves a series of acquisitions of National Industries Common stock by National and by Madison Fund, Inc., a large mutual fund, during the two years immediately preceding the issuance of the proxy statement. The second omission involves a reference in the statement to an opinion letter from Hornblower &

15. National filed its Schedule 13D on February 14, 1969. TSC filed its Form 10-K on February 27, 1969 and its Form 8-K on March 7, 1969. The election of officers of the TSC board of directors took place on March 31, 1969.

Weeks-Hemphill, Noyes indicating their favorable evaluation of the proposed transaction, when no similar reference was made to a subsequent letter from that firm which more particularly described the basis for the original opinion and indicated that Hornblower expected the market value of the National Warrants being offered to decline substantially prior to the proposed exchange. We hold that these omissions were also material and in violation of Rule 14a-9.

The joint proxy statement contained a major section entitled "Proposed Agreement to Sell TSC's Assets to National and Liquidation and Dissolution of TSC." The first information which appeared in this section concerned the approval of the proposed agreement by the boards of directors of National and TSC. The shareholders were told that the boards of directors of both corporations believed the proposal to be in the best interests of their shareholders, based in part on "recent market prices of the securities of the two corporations." The shareholders were also informed of the favorable opinion of the Hornblower firm regarding the fairness of the transaction to the stockholders of TSC. Current market values of the securities involved were listed as one of the bases for the Hornblower opinion, with specific reference to a "substantial premium over current market values represented by the securities being offered to TSC stockholders."[16]

16. The Boards of Directors of National and TSC have approved the Agreement and believe that the transactions contemplated thereby are in the best interests of the shareholders of both corporations, who will benefit through the diversified activities of the surviving corporation. In reaching their decision the Boards of Directors of each corporation considered not only recent market prices of the securities of the two corporations, but also the preferred dividend to be paid to the TSC stockholders, the businesses and financial conditions of both corporations and various other factors.

At the request of TSC, the investment banking firm of Hornblower & Weeks-Hemphill, Noyes rendered a favorable opinion as to the fairness to the stockholders of TSC of the terms, set forth below, for the exchange of the shares of TSC for securities of National. The TSC Board considered this opinion in approving the sale. In such opinion, said firm con-

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Following this information the terms of the proposed exchange were set out. According to those terms holders of TSC Series 1 Preferred Stock were to receive .6 share of National Series B Preferred Stock and one National Warrant for each of their shares. Each holder of TSC Common Stock was to receive .5 share of National Series B Preferred Stock and 1.5 National Warrants for each of his shares. One of the characteristics of National Series B Preferred was that each such share would be convertible into National Common Stock. Each National Warrant entitled its holder to purchase one share of National Common at $21.40 per share until October 31, 1978.

By linking the evaluation of the proposed exchange to current market values, the proxy statement invited shareholders to rely on a table of market values which appeared three pages later in that statement. The table included market prices of all of the securities involved in the proposed exchange for 1967, 1968 and 1969 up to November 7, 1969; the closing prices on November 7 were set out separately at the bottom of the same page.[17] By using simple arithmetic, any TSC shareholder could thus determine the apparent premium which would result from the proposed rates of exchange based on the latest market figures. Based on these simple calculations, the premiums disclosed were indeed "substantial" as had been indicated earlier in the proxy statement. Each holder of TSC Series 1 Preferred, which closed on November 7 at $12.00, would be receiving National securities worth $15.23 at that closing, while each holder of TSC

sidered, among other things, the current market prices of the securities of both corporations, the high redemption price of the National Series B Preferred Stock, the dividend and debt service requirements of both corporations, the substantial premium over current market values represented by the securities being offered to TSC stockholders, and the increased dividend income.

17. The November 7, 1969 closing prices were as follows:

National Series B Preferred Stock	$16⅝
National Warrants	$ 5¼
TSC Common Stock	$13¼
TSC Series 1 Preferred Stock	$12

common, which closed at $13.25 on that day, would be receiving National securities worth $16.19.[18]

The shareholders were not told that in a subsequent communication the Hornblower firm had predicted that when issued, the National Warrants involved in the exchange would have declined from the November 7 closing price of $5.25 to a market value of $3.50. Such a disclosure would have reduced the apparent premium being offered TSC shareholders by fifty-four percent for holders of Series 1 Preferred and eighty-nine percent for holders of TSC Common.[19] Both corporations were aware of the likelihood of such a decline. The topic was discussed at the TSC board meeting which considered the proposed liquidation and sale, and the subsequent Hornblower opinion letter was specifically requested by National.

In simple terms, TSC and National had received some good news and some bad news from the Hornblower firm. They chose to publish the good news and omit the bad news. Thus, TSC shareholders who relied on the joint proxy statement were led to believe that Hornblower considered the current market values disclosed in the proxy to be accurate indicators of the

18. Each holder of TSC Preferred would receive .6 National B Preferred (.6 × $16⅝ = $9.98) plus one National Warrant ($5.25) or a total value of $15.23 for his $12 TSC Preferred share; each holder of TSC Common would receive .5 National B Preferred (.5 × $16⅝ = $8.31) plus 1.5 National Warrants (1.5 × $5.25 = $7.88) or a total value of $16.19 for each of his $13.25 TSC Common shares. Thus, the apparent per share premiums would be $3.23 and $2.94, respectively.

19. The holders of TSC Preferred, whose apparent premium had been $3.23 per share, would have to deduct the difference between the market value disclosed and the Hornblower adjusted value of National Warrants, or $5.25 − $3.50 = $1.75. Their premium would therefore be reduced by 54% from $3.23 to $1.48 per share. The reduction for holders of TSC Common would be greater since their exchange involved 1.5 Warrants per share. Thus, from an apparent premium of $2.94, each holder would have to deduct ($5.25 − $3.50) × 1.5 = $2.63. This equals a total premium diminution of 89% from $2.94 to $.31 per share of TSC Common.

"profit" to be generated by the exchange being proposed. This wasn't true. The materiality of the omission is obvious.

Additionally, stockholders of TSC should have been informed of substantial purchases of National Common stock by National and by Madison Fund, Inc. during 1968-69,[20] and that between the Schmidt acquisition by National on January 31, 1969 and the proxy solicitation on November 12, 1969 these two corporations accounted for 8.5% of all reported transactions in National Common stock. It is not disputed that Mr. Edward Merkle, president of Madison Fund, was a paid consultant of National receiving $12,000 per year[21] for "being available" to National for at least one day per month,[22] nor is

20. During this period, National and Madison acquired approximately 260,000 shares of National Common stock. In addition Madison acquired $2 million in National debentures convertible to common. There is no mention whatever of the Madison purchases in the joint proxy statement, and while the National acquisition of approximately 80,000 shares of National common is reflected in a table entitled "Statements of Consolidated Stockholder's Equity," which appears on page 63 of the proxy statement, and note J to that table, which appears at the bottom of page 69, this disclosure is insufficient under the "equal emphasis" rationale of this court's decision in *Mills* v. *Electric Autolite Company,* 403 F. 2d 429 (7th Cir. 1968) rev'd on other grounds, 396 U. S. 375, 90 S. Ct. 616, 24 L. Ed. 2d 593 (1969). Just as the board in *Mills* "was not free to state its recommendation and opinion favoring the merger without giving similar emphasis to the relationship between the directors and the other party to the bargain," 403 F. 2d at 434, neither were National and TSC free to emphasize and highlight the importance of current market values of National securities at the beginning of the proxy statement and then bury a partial disclosure of material information affecting those values in a barrage of statistics and footnotes fifty pages later.

21. Mr. Merkel's [sic.] original agreement with National provided a salary of $2,500 per year. On October 1, 1968 this figure was raised to $12,000. Two days later, on October 3, 1968, Madison acquired $2 million in National debentures convertible into its common stock.

22. On July 19, 1972, Mr. Merkel [sic.] consented to the entry of an order by the SEC finding in part that he had caused Madison to purchase 182,500 shares of National Common and National convertible bonds in the amount of $2 million without disclosing that he was a salaried employee of National. In re Merkel, SEC Investment Co. Release No. 7280 (July 19, 1972). The consent was given solely for the purposes of settlement, according to the order.

it disputed that the chairman of National's board of directors, Bernard Barnett, was a director of Madison.

The trial judge found that these facts, coupled with the peculiar timing of the National and Madison acquisitions,[23] showed "the opportunity for coordination." 361 F. Supp. at 116. The judge held, however, that while "the inference that might be drawn from [this] evidence might support a finding of corodination, the Court is not free to draw such inferences." *Id.* But the purpose of 14a-9 is to allow the stockholders to draw such inferences as they see fit before their final decision on proxy questions. While we agree that collusion is not conclusively established by the omitted facts, it is certainly suggested. Stockholders contemplating an offer involving preferred shares convertible to common stock and warrants for the purchase of common stock must be informed of circumstances which tend to indicate that the current selling price of the common stock involved may be affected by apparent market manipulations. It was for the shareholders to determine whether the market price of the common shares was relevant to their evaluation of the convertible preferred shares and warrants, or whether the activities of Madison and National actually amounted to manipulation at all. This is the very purpose of disclosure.

We therefore hold that failure to disclose the unfavorable opinion letter from Hornblower and the facts surrounding the National-Madison acquisitions also violated Rule 14a-9 as a matter of law.

23. National and Madison never made purchases during the same week; in individual weeks, the percentages of total reported trading by them ran as high as 66% for Madison and 35% for National. Madison and National purchases were consistently substantial during periods relevant to previous National take-over bids directed to other corporations and their stockholders, and when National Common showed definite signs of weakening on the market.

C

Northway's final claim under 14a-9 is that the proxy statement was materially misleading in its unqualified assertion that the TSC board of directors had approved the proposed liquidation and sale. First, Northway asserts that the proposal was never legally approved under the applicable Delaware law. The district judge found that § 144 of the Delaware Corporation Law[24] covered the approval procedure in this case and that under that section, the approval vote was legally sufficient.[25] In view of our disposition of Northway's other claims

24. DEL. CODE ANN. TIT. 8, § 144 (1969).

§ 144. INTERESTED DIRECTORS: QUORUM.—(a) No contract or transaction between a corporation and one or more of its directors or officers, or between a corporation and any other corporation, partnership, association, or other organization in which one or more of its directors or officers are directors or officers, or have a financial interest, shall be void or voidable solely for this reason, or solely because the director or officer is present at or participates in the meeting of the board or committee thereof which authorizes the contract or transaction, or solely because his or their votes are counted for such purpose, if;

(1) The material facts as to his relationship or interest and as to the contract or transaction are disclosed or are known to the board of directors or the committee, and the board or committee in good faith authorizes the contract or transaction by the affirmative votes of a majority of the disinterested directors, even though the disinterested directors be less than a quorum; or

(2) The material facts as to his relationship or interest and as to the contract or transaction are disclosed or are known to the shareholders entitled to vote thereon, and the contract or transaction is specifically approved in good faith by vote of the shareholders; or

(3) The contract or transaction is fair as to the corporation as of the time it is auth rized, approved or ratified, by the board of directors, a committee thereof, or the shareholders.

(b) Common or interested directors may be counted in determining the presence of a quorum at a meeting of the board of directors or of a committee which authorizes the contract or transaction.

25. Under normal circumstances, a proposal requiring dissolution would require a majority of the whole board, or in this case,

(Footnote continued on next page)

and in view of the fact that this issue has not been resolved by the courts of Delaware, we decline to reach the question. We do note, however, that Professor Folk, whose article[26] was relied upon by the district judge, has stated that he never intended his article to indicate that the procedure followed by the TSC board would be legally sufficient to adopt a resolution of dissolution and liquidation. It is Professor Folk's opinion that the TSC board never legally approved the proposed resolution under Delaware law.[27]

six votes:

§ 275. DISSOLUTION; PROCEDURE.—(a) If it should be deemed advisable in the judgment of the board of directors of any corporation that it should be dissolved, the board, after the adoption of a resolution to that effect by a majority of the whole board at any meeting called for that purpose, shall cause notice to be mailed to each stockholder entitled to vote thereon of the adoption of the resolution and of a meeting of stockholders to take action upon the resolution.

* * *

DEL. CODE ANN. TIT. 8 § 275 (1969).

26. Folk, *Corporation Law Developments,* 56 Va. L. Rev. 755, 782 (1970).

27. Professor Folk was contacted by letter by Mr. Arnold Shure, attorney for Northway. In his reply letter, dated July 19, 1973 and filed with the district court on July 24, 1973 as Exhibit A to Plaintiff's Reply to Corporate Defendants' Objections Concerning Plaintiff's Motion Under 28 U. S. C. § 1292(b), Professor Folk states:

The question on which you seek clarification of my views is whether the affirmative votes of disinterested directors, comprising less than a quorum of the board of directors, will be sufficient to approve a resolution calling for the dissolution of a corporation when Section 275(a) requires action "by a majority of the whole board." In my view, a resolution of dissolution adopted by less than a majority of the board of directors (even though those directors have no "interest" in the dissolution) is not effective action by the board for purposes of complying with the specific mandate of Section 275(a). I do not consider that the statement in my article implies or suggests that such a resolution has been effectively approved, and, indeed, that the implications of my statement are the other way. It is this issue which I now analyse.

. . . .

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A second facet of Northway's final claim remains. The resolution of dissolution and liquidation was presented to a meeting of the TSC board on October 16, 1969. Attending that meeting were eight of the ten directors who comprised the board at that time. Charles F. Simonelli and Hyman Ullner, both National nominees, were absent from the meeting. The proposal was summarized for the board by Mr. Allan Solomon, another National nominee. A period of discussion ensued and a vote was called. The three National nominees attending the meeting announced that though they felt this was a good proposal, they had been advised by their attorneys not to vote on the matter.[28] Orville E. Peterson, who had just negotiated the sale of his TSC stock to National for cash and notes payable over five years, also abstained in view of this recent sale. The four remaining directors voted in favor of the proposal to liquidate and to sell to National.

Northway points out that the resolution of dissolution and liquidation was thus passed upon by a minority of the entire board and that the resolution never received a simple majority of those present and eligible to vote at the October 16th meeting. They contend that these facts are so unusual that even if Delaware law allows such a procedure, the stockholders would want to know that the proposal received only four affirmative votes and that those interested directors who could have voted were cautioned against doing so by their legal advisors.

My position is that Section 144 of the Delaware Corporation Law does not state rules as to formal effectiveness of action by a board of directors. It states rules as to when formally effective action may or may not be challenged because of a conflict of interests. To be specific, Section 275 declares the formalities necessary to adopt an effective resolution of the board of directors calling for dissolution of a corporation. That formality is approval "by a majority of the whole board." Section 144(a)(1) does not undercut this statutory requirement for effective action by the board of directors. The role of Section 144, in my judgment, is to predict and determine when formally effective action under Section 275(a) will be held valid or voidable, under Section 144, as the case may be, because of an alleged conflict of interests.

28. Messrs. Segell, Solomon and Yarmuth.

While we agree that the passage of an extraordinary resolution by four affirmative votes out of a total of ten board members is highly unusual, we do not think that this, standing alone, is the type of information which is clearly relevant to a shareholder's decision to approve the underlying proposal. We further believe that reasonable minds could differ on the question of whether or not a reasonable shareholder might consider this information important to his decision. Such information is not related to the substance of the liquidation and sale proposal as is information which reflects on the market value of securities involved nor is it as suggestive of self-dealing as is information related to possible control relationships between the participating corporations. Without other facts, this information may only indicate that those who favored the transaction but felt a possible conflict did not wish to taint the vote of the disinterested board members who also approved of the proposal. The materiality of this omission is not properly determined on motion for summary judgment.

III

The Schmidt defendants are charged with violations of § 10(b) of the Securities and Exchange Act of 1934, 15 U.S.C. § 78j(b), and Rule 10b-5[29] thereunder, and with aiding and

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29. Rule 10b-5, 17 C. F. R. § 240.10b-5, provides:

It shall be unlawful for any person directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

(1) to employ any device, scheme, or artifice to defraud,

(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made not misleading, or

(3) to engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

abetting the corporate defendants in the various fraudulent activities charged against them in the plaintiff's complaint.[30]

Count III of the complaint sets out the following wrongful acts upon which recovery from the Schmidt defendants is sought:

> (a) Said defendants failed to have included in said agreement, and failed to make any effort or attempt to have included therein, any terms or provisions to insure that National would not acquire or attempt to acquire complete ownership of TSC, except at a price and on terms at least equal to and not less favorable than those accorded by National to the Schmidt defendants.
>
> (b) Said defendants failed to have included in said agreement, and failed to make any effort or attempt to have included therein, any terms or provisions to insure that National would not utilize its control of TSC to its own exclusive advantage and to the detriment of TSC and its independent stockholders.
>
> (c) Said defendants transferred actual or working control of TSC to National, and aided and abetted National in acquiring complete ownership of TSC for newly issued equity securities at a fraudulently low and grossly inadequate consideration and at a price and on terms which were substantially less favorable to TSC and the independent stockholders of TSC than those accorded the Schmidt defendants, and which were otherwise grossly unfair to TSC and the independent stockholders of TSC.
>
> (d) Said defendants transferred their shares of TSC to National in a manner which resulted in their receiving a substantially higher price for their shares than was received by the independent stockholders of TSC, which higher price was payable in cash and notes of National which were senior to the substantially less valuable equity securities of National received by the independent stockholders of TSC and which would be payable to said Schmidt defendants wholly or partly out of the earnings and cash flow of TSC.

30. In addition to the proxy violations discussed above, the corporate defendants were charged with pursuing various fraudulent activities aimed at securing an unfair advantage over the TSC shareholders in violation of Rule 10b-5. All of the alleged fraudulent activities took place after the acquisition of the Schmidt interests by National.

> (e) Said defendants in disposing of and transferring, actual or working control of TSC to National, wrongfully used and employed said actual or working control to their own exclusive benefit and to the detriment and injury of TSC and its independent stockholders, and failed to exercise due and proper care and diligence to protect the interests of TSC and its independent stockholders.

The trial court properly found that the first two specific alleged violations, (a) and (b), fail to state a claim. Although it is clear that a stockholder who holds a controlling interest in a corporation owes a fiduciary duty to protect the corporate interests and to avoid exhaulting his own interests above those of the corporation or its other shareholders,[31] that recognized obligation is not without reasonable limitations. No court has yet intimated that the holder of a controlling interest must indemnify all other shareholders from adverse market trends in order to fulfill his obligations to those shareholders in transferring control.[32] Nor has any court ever required the inclusion in such a bargain of a covenant by the acquiring party not to do what the law already prohibits. The mandatory inclusion of either such covenant would have far reaching and unfortunate effects. The first requirement would make the transfer of controlling interests almost impossible since no prudent investor, conglomerate or otherwise, would presume to guarantee any specific price for future acquisitions of a fluctuating security. The second requirement would do more to demean the fiduciary concepts here involved than to preserve them since any such provision, if judicially imposed, would merely become boilerplate in all prudent stock purchase agreements. These two specific claims were properly stricken.

31. *See e.g., Pepper* v. *Litton*, 308 U. S. 295, 60 S. Ct. 238, 84 L. Ed. 281 (1939), *Southern Pacific Co.* v. *Bogert*, 250 U. S. 483, 39 S. Ct. 533, 63 L. Ed. 1099 (1919), *Lebold* v. *Inland S. S. Co.*, 82 F. 2d 351 (7th Cir. 1936).

32. *Percodani* v. *Rikes-Maxson Corp.*, 50 F. R. D. 473, 475, 478 (S. D. N. Y. 1970), on which Northway relies, does not suggest such a *requirement.*

Specific allegation (c) charges the Schmidt defendants with aiding and abetting the corporate defendants in the fraudulent acquisition of the remaining securities of TSC. Since there is nothing in the record to indicate that any of the Schmidt defendants had any contact with either National or TSC subsequent to the transfer of the Schmidt interests on or about February 7, 1969, the basis for such a charge must find support in the limited contacts between National representatives and Charles E. Schmidt, Sr. in the brief period between January 6, 1969, when Mr. Schmidt first became aware of National's interest, and the execution of the stock purchase agreement on January 30, 1969.

An examination of the relevant portions of the record reveals no suggestion that Schmidt in any way facilitated the fraudulent take-over by National other than by selling the Schmidt interests to National. This, standing alone, does not constitute aiding and abetting. There is no indication that any one of the Schmidt defendants was consciously involved in a scheme to procure a premium for control, or that any of these defendants were on constructive notice that National intended to commit a fraud in any future transaction. The evidence is all the other way. An investigation of National Industries and its executive personnel initiated by Schmidt did not disclose any prior fraudulent activities by National, and the Schmidts were assured by reliable sources that the National people were top flight in every respect. Under these circumstances there is simply no connection between the Schmidt defendants and National's later activities, and there is certainly no hint that the Schmidts in any way anticipated, or could have anticipated, the use of a fraudulent proxy statement.

As the trial court pointed out, each of the cases relied upon by Northway is distinguishable from the present situation. In each of those cases there was an involvement contemporaneous with and essential to the fraud. In *Brennan* v. *Midwestern United Life Insurance Company*, 417 F. 2d 147 (7th Cir. 1969),

cert. denied, 397 U. S. 989 (1970), Midwestern had failed to report complaints they received about the activities of a stockbroker to the Indiana Securities Commission when circumstances indicated a clear possibility of misuse of Midwestern's Securities by that broker. It was specifically found that

> Midwestern's actions amounted to a tacit agreement with [the broker] to prevent complaints from reaching the Commission, thus facilitating the fraud and allowing [the] scheme to continue to Midwestern's benefit. *Id.* at 155.

The allegations reviewed in *Buttrey* v. *Merril Lynch, Pierce, Fenner & Smith*, 410 F. 2d 135 (7th Cir. 1969), *cert. denied*, 396 U. S. 838 (1969) disclosed a similar situation:

> Here it is alleged that defendant knew or should have known of the bankrupt's scheme to convert securities investment funds and nevertheless enabled the bankrupt to engage in large-scale speculations with its customers' funds through defendant's office. . . . [W]e are persuaded that Count II sufficiently alleges that defendant benefited by a course of business which operated as a fraud upon the bankrupt's customers to entitle those customers, through the trustee in bankruptcy, to recover the net transfers of the funds so converted. *Id.* at 144.

Our opinion in *Carroll* v. *First National Bank of Lincolnwood*, 413 F. 2d 353 (7th Cir. 1969), *cert. denied*, 396 U. S. 1003 (1970) merely held that a complaint which charged that the defendant bank was a "main participant in a scheme to defraud by active concealment of that scheme" stated a claim on the theory of aiding and abetting. Finally, in *SEC* v. *First Securities of Chicago*, 463 F. 2d 981 (7th Cir. 1972), *cert. denied*, 409 U. S. 880 (1972), we held that First Securities had aided and abetted its president in defrauding various of its regular clients by holding him out as a successful investment counsellor and then wilfully allowing him to enforce a rule prohibiting anyone from opening his mail—a rule which prevented the discovery of his fraudulent scheme during its operation. Clearly the involvement disclosed in these cases far

surpasses any involvement of the Schmidt defendants in the take-over, if it could be said there was any involvement.

The trial court correctly found that the exhibits and evidence before it on defendants' motion for summary judgment raised no genuine issue as to any fact which would establish liability under the theory of aiding and abetting.

Specific claim (d) was not separately considered by the trial court in its opinion, but was merged with the discussion of claims (c) and (e). To the extent that this claim relies on the higher compensation received by the Schmidts, the disposition of claim (a) controls here. To the extent that it charges a conscious plan to have the remaining TSC shareholders indirectly bear the burden of an exorbitant compensation for the Schmidt interests, *cf. Dasho* v. *Susquehana* [sic.], 380 F. 2d 262 (7th Cir. 1967), the claim finds no support in the record. There is no evidence of any conscious plan, and the expert witnesses of both plaintiffs and defendants concluded that the Schmidts received no more than market value for their shares.[33]

Specific claim (e), plaintiff's last claim, adds the charge that the Schmidts failed to fulfill their fiduciary obligations to the minority shareholders by making an insufficient investigation of National prior to transferring control.[34] Again, the record fails

33. In March of 1969, at National's request, the firm of Bear, Stearns & Co. evaluated the consideration paid to the Schmidts at $21,053,407.18; the closing prices of the TSC common and preferred stock on the New York Stock Exchange on the date on which the stock purchase agreement was signed were 27⅝ for TSC common and 21⅛ for TSC preferred. These prices produce a total market value of $21,296,224.63 for the Schmidt interests on that day.

Professor Erwin E. Nemmers, Northway's expert witness, testified that the fair market values of the Schmidt interests, on a per share basis, ranged from $29.80 to $36.40 for the common shares and from $22.55 to $27.30 for the preferred shares. By any analysis, the per share consideration received by the Schmidts falls well within these ranges.

34. The control issue itself remains a factual question. Our consideration of this claim assumes that control was in fact transferred by the Schmidts.

to support the claim. It is undisputed that the Schmidt transfer was finalized only after Schmidt, Sr. had 1) analyzed a National prospectus for a recent debenture offering which supplied considerable information about National management, disclosed that National was associated with several highly reputable investment banking firms, and showed that National was able to market debentures at a very favorable interest rate; 2) recognized the names of two highly respected persons on the National board of directors, persons Schmidt felt "would be in a position to do things for and with" TSC; 3) reviewed, with the help of Richard Schaefer, then an executive officer and member of the board of TSC, various financial reports regarding National Industries; and 4) met with top officers of First National City Bank of New York who indicated their bank was well acquainted with National Industries, that the National people were top flight people who always kept their commitments, and that Stanley Yarmuth, president, director, and chief executive officer of National was very highly regarded by First National City Bank.

Northway contends that having discovered no unfavorable information at this point, the Schmidts were obliged to keep digging. There is no suggestion, however, as to what further steps would have been appropriate, other than a rather pointless suggestion that Schmidt should have inquired whether National intended at that point to commit a fraudulent take-over. But the duty to investigate those to whom one transfers a controlling interest in a corporation, like other fiduciary duties, does not exist in a vacuum. It takes its meaning in part from the circumstances in which it is confronted. Thus, in *Insuranshares Corp.* v. *Northern Fiscal Corp.*, 35 F. Supp. 22 (E.D. Pa. 1940), the court emphasized the relation between the scope of the duty of investigation and the setting in which the transfer is made:

> Those who control a corporation . . . owe some duty to the corporation in respect of the transfer of the control

> to outsiders. [S]uch persons may not be wholly oblivious of the interests of everyone but themselves. . . . Without stating any general definition, and stating the duty in minimum terms . . . it may be said that the owners of control are under a duty not to transfer it to outsiders if the circumstances surrounding the proposed transfer are such as to awaken suspicion and put a prudent man on his guard—unless a reasonably adequate investigation discloses such facts as would convince a reasonable person that no fraud is intended or likely to result. Thus, whatever the primary duty may be, circumstances may be sufficient to call into being the duty of active vigilence and inquiry. *Id.* at 25.

In *Insuranshares*, the court found numerous factors which "were sufficient to indicate to any reasonable man in his position that the [purchasing parties] were acquiring the control of the corporation by improper means and for an improper purpose." *Id.*

Although we are unable to read *Insuranshares* as holding that absent suspicious circumstances there is no duty to investigate prior to the transfer of a controlling interest, we agree that the duty in every case is tied to the nature of the peculiar circumstances which exist at the time of such a transfer. We find that the evidence before the trial court in this case presented no facts which would indicate that the Schmidt defendants were under a duty to investigate further than they did. The granting of the Schmidt defendants' motion for summary judgment was therefore proper as to claim (e).

The order of the district court granting summary judgment in favor of the Schmidt defendants is affirmed. The denial of summary judgment in favor of plaintiff Northway and against defendants National Industires, Inc. and TSC, Inc. on the issue of liability is reversed, and the cause is remanded for further proceedings consistent with this opinion.

A true Copy:

Teste:

Clerk of the United States Court of Appeals for the Seventh Circuit

APPENDIX B.

IN THE UNITED STATES DISTRICT COURT,
For the Northern District of Illinois,
Eastern Division

NORTHWAY, INC., a Delaware corporation,
Plaintiff,
vs.
TSC INDUSTRIES, INC., a Delaware corporation, et al,
Defendants.
No. 69 C 2513

MEMORANDUM OPINION AND ORDER.

This matter arises upon plaintiff's motion for partial summary judgment of liability against the corporate defendants[1] (referred to as "defendants" in Part I below) and the Schmidt defendants' motion for certification pursuant to Fed. R. Civ. P. 54(b) of the order of September 28, 1972,[2] granting summary judgment on Count III of the amended, restated and supplemented complaint.

I.

There is no substantial factual dispute as to the following background. In early 1969, defendant National purchased the Schmidt defendants' interest in TSC, comprising approximately 34% of its outstanding equity securities. After consideration by the TSC board, a proxy statement dated November 12, 1969, (hereinafter referred to as "the joint proxy statement") was sent to the TSC shareholders proposing that TSC sell its assets to

1. TSC Industries, Inc. ("TSC"), National Industries, Inc. ("National"), and TS Liquidating Company.

2. Attached hereto as an appendix.

National, and be liquidated (referred to below as "the transaction"). Sufficient proxies were received for the approval of the proposal.

Plaintiff's instant motion is confined, without waiver of the other charges of the complaint, to alleged violations of § 14(a) of the Securities Exchange Act of 1934, 15 U. S. C. § 78n(a), and the rules promulgated thereunder, in the joint proxy statement. The alleged violations for which plaintiff seeks partial summary judgment as to liability fall into three categories:

A. The inadequacy of disclosure of National's relationship to TSC's management and directors.

B. The misrepresentation of the TSC directors' approval of the transaction.

C. The non-disclosure of facts which would have made the emphasis on market quotations not misleading.

A.

1. Plaintiff first contends that the failure to disclose the change in control of TSC, which had previously been reported to the Securities & Exchange Commission ("SEC"), "constituted a *per se* violation of Rule 14a-3," 17 C. F. R. § 240.14a-3.

Rule 14a-3(a) provides that:

> "No solicitation subject to this regulation shall be made unless each person solicited is concurrently furnished or has previously been furnished with a written proxy statement containing the information specified in Schedule 14A."

Schedule 14A, Item 5, requires:

> "(e). If to the knowledge of the persons on whose behalf the solicitation is made a change in control of the issuer has occurred since the beginning of the last fiscal year, state the name of the person or persons who acquired such control, the basis of such control, the date and a description of the transaction or transactions in which control was acquired and the percentage of voting securities of the issuer now owned by such person or persons."

Plaintiff contends that the joint proxy statement should have stated the conclusion of change of control. As evidence that National was in control of TSC, plaintiff points to one document sent by National and two sent by TSC to the SEC stating that National could be "deemed to be a 'parent' of TSC as that term is defined in the Rules and Regulations under the Securities Act of 1933." Rule 405(n), 17 C. F. R. § 230.405(n), under the 1933 Act, defines a parent as an affiliate "controlling" a person.

Defendants assert that National was not, in fact, in control of TSC within the meaning of Item 5(e), notwithstanding the statements to the contrary in the SEC filings. Rule 12b-2(F), 17 C. F. R. § 240.12b-2(F), under the 1934 Act, and therefore relating to Item 5(e), defines control as "the possession . . . of the power to direct or cause the direction of the management of a person. . . ." Defendants point to the affidavit of Richard Shaefer, the president of TSC, and certain deposition testimony by him and by Stanley Yarmouth [sic.], who was chairman of the board of TSC and president of National at the time of merger, as evidence that National lacked the power to direct or cause the direction of TSC's management. The affidavit and deposition testimony show that Shaefer managed TSC without consulting with or answering to National. This creates an inference, to which defendants are entitled in opposing a motion for summary judgment, that National was not in control of TSC.

Plaintiff cites *Mills* v. *Electric Auto-Lite Co.*, 403 F. 2d 429, 434 (7th Cir. 1968), *rev'd on other grounds*, 396 U. S. 375 (1970), for the proposition that evidence such as that presented by defendants does not preclude summary judgment. The Seventh Circuit held that evidence of the independence of management did not "meet the point presented." The point there was whether the proxy statement was otherwise materially misleading in violation of Rule 14a-9, 17 C. F. R. § 240.14a-9. The situation here is different; such evidence does meet the issue of control presented here by plaintiff's 14a-3 theory.

Thus, viewing the evidence and the inferences therefrom in the light most favorable to defendants, the Court holds that plaintiff has failed to establish the absence of a genuine question of fact as to the material issue of whether National was in control of TSC. Plaintiff's motion for partial summary judgment of liability is accordingly denied as to the Rule 14a-3 ground.[3]

2. Plaintiff also seeks summary judgment of liability on the ground that the joint proxy statement failed, in violation of Rule 14a-9, to adequately disclose the relationship between National and TSC. To establish a violation, plaintiff must prove (a) that the joint proxy statement falsely or misleadingly described the relationship or omitted facts necessary to make the description not false or misleading and (b) that the misstatement or omissions were material in the sense that they "might have been considered important by a shareholder who was in the process of deciding how to vote." *Mills*, 396 U. S. at 374. To establish liability plaintiff must show the additional element of causation. Causation is not disputed here because defendants have admitted in their answer and in response to a request to admit that proxies necessary to the approval of the transaction were obtained from TSC shareholders by the joint proxy statement. *Id.* at 386.

The pivotal question as to plaintiff's motion for summary judgment on this ground is thus whether certain facts relating to the relationship between TSC and National which were omitted from the joint proxy statement were, as a matter of law, material. To meet its burden, plaintiff must show that the facts withheld were so obviously important to TSC shareholders that reasonable minds could not differ on the question of whether the shareholders might have considered them important. *Gould* v. *American Hawaiian S. S. Co.*, 331 F. Supp. 981,

3. The Court has solicited the opinion of the SEC as to whether, if it is shown at trial that National was in control, the joint proxy statement sufficiently disclosed the change of control to satisfy Item 5(e) of Schedule 14A.

986 (D. Del. 1971); *Beatty* v. *Bright*, 318 F. Supp. 169, 173 (S. D. Iowa 1970); *Berman* v. *Thompson*, 312 F. Supp. 1031, 1034 (N. D. Ill. 1970).

Of course, insofar as plaintiff seeks to impose liability for the joint proxy statement's failure to specify that National was in control of TSC, its motion must be denied because of its failure to show the absence of a question of fact as to control.

3. Plaintiff also seeks partial summary judgment on the grounds that the previous *claims* of control made to the SEC should have been disclosed to make the recommendations of the transaction by the TSC mangement and board of directors not misleading.

Pages six and seven of the joint proxy statement set forth under separate headings the approval and recommendations of the National and TSC boards of directors, National's equity interest in TSC and how it was acquired, and National's nominees on TSC's board.

Plaintiff argues that, despite the disclosure of National's equity interest and nominees, the previous claims of control made to the SEC might have been considered important by TSC shareholders faced with the TSC board's recommendation because all except one of the directors who were stated not to be affiliated with National were employees of TSC and thus subject to National's claimed power to direct or cause the direction of TSC's management.

Plaintiff also attacks on the same theory the statement in the covering letter to the shareholders that "management urges you to mark your proxy FOR this purchase of TSC assets. . . ." The allegedly misleading effect of the failure to disclose the prior claims of National's power to direct TSC's management is claimed to have been aggravated by the failure to state that Stanley Yarmuth, the chief executive officer of National, was TSC's chief executive officer as chairman of its board and that Charles Simonelli, executive vice-president of National, was chairman of TSC's executive committee.

Plaintiff relies principally upon the Seventh Circuit's *Mills* decision, *supra; Swanson* v. *American Consumer Industries, Inc.*, 415 F. 2d 1326 (7th Cir. 1969); and *Colonial Realty Corp.* v. *Baldwin-Montrose Chem. Co.*, 312 F. Supp. 1296 (E. D. Pa. 1970), in support of its claim that the disclosure of National's relationship to TSC was inadequate under Rule 14a-9.

The *Mills* opinion (403 F. 2d at 434) and *Swanson* (415 F. 2d at 1330) which relied upon it, establish that the TSC board and management were not free to state their recommendations favoring the transaction without giving similar emphasis to the relationship between them and National. In *Mills*, the court of appeals considered several factors in reaching its determination that the proxy failed, as a matter of law, to adequately bring out the relationship between the Auto-Lite board and Mergenthaler. The Court noted that greater emphasis was given to the Auto-Lite board's recommendation of the merger, through larger and heavier type and placement near the beginning of the proxy statement, than to Mergenthaler's ownership of 54% of the Auto-Lite stock, the number and positions of Mergenthaler nominees on Auto-Lite's board, the fact that all Auto-Lite directors would be on the board of the new corporation, and that two of the Auto-Lite directors who also were directors of Mergenthaler and a third corporation, American, had claimed in a SEC hearing that American controlled the operations of Mergenthaler and Auto-Lite, that seven of Auto-Lite's directors were nominees of Mergenthaler, and that the four remaining Auto-Lite directors were "kept" because of their understanding of the company and their positions in the community. 403 F. 2d at 433-34.

In *Swanson*, decided under Rule 10b-5 rather than 14a-9, Peoria's board recommended that its stockholders vote in favor of the reorganization plan, but failed to disclose that the other party to the bargain, ACI, was the parent of U. S. Cold which it was disclosed would vote its 87% of the shares of Peoria

for the sale, and that the board was composed solely of ACI officers and directors. Based upon this concealment of the board's conflict of interest, the failure to provide an appraisal value for Peoria's assets, the statement that the Peoria stock was relatively worthless, and the concealment of ACI's plan to exploit a corporate opportunity of Peoria, the court concluded that the proxy statements were misleading in material respects and deceptive as a matter of law. 415 F. 2d at 1330-31.

Baldwin-Montrose is a difficult decision. The court there concluded that the joint proxy statement's failure to state that Baldwin-Montrose believed that it had clearly obtained working control of Chris-Craft (which had been stated in an SEC hearing) entitled plaintiff to summary judgment on the issue of liability under §§ 10(b) and 14(a). The *Mills* test for violations of Rule 14a-9 was recited, but no explanation of how the failure to state Baldwin-Montrose's belief made the statements in the proxy statement false or misleading was given. Although the court concluded that the defect was of such a character that it might have been considered important by a reasonable shareholder in the process of deciding how to vote, there was no finding that reasonable minds could not differ on this issue. Further, the court certified its order pursuant to 28 U. S. C. § 1292(b) as involving a controlling question of law as to which there was a substantial ground for difference of opinion. No decision on appeal has been reported, however.

Unlike the proxy statement dealt with in *Mills*, the joint proxy statement complained of here gives similar emphasis to the board's recommendation, National's equity interest in TSC, and the number and some of the positions of National's nominees. If the TSC shareholders were misled as to National's relationship to TSC, the circumstances under which this occurred can hardly be compared to the total concealment of the conflict of interest in *Swanson*. The failure to disclose the prior claim of control for which plaintiff seeks to impose liability was only one of the factors considered in *Mills;* it is not clear that the

Mills court would have held the proxy statement to be in violation of Rule 14a-9 based solely on this omission. The conclusion reached in *Baldwin-Montrose* supports plaintiff's theory, but the lack of analysis, the failure to find that reasonable minds could not differ on the issue of materiality, and the court's willingness to certify the issue for appeal deprive that opinion of much of its value as precedent.

It has been recognized that "[i]t is easy to find small errors and trivial omissions in any proxy statement. . . ." *Allen* v. *Penn Central Co.*, 350 F. Supp. 697, 702 (E. D. Pa. 1972). In passing on plaintiff's motion for partial summary judgment, the Court has considered the omitted facts in light of the manner in which other facts were disclosed which could have alerted the TSC shareholders to the possible bias of the management and board of TSC. *Cf. Kohn* v. *American Metal Climax, Inc.*, 458 F. 2d 255, 267 (3d Cir. 1972). While the Court believes that the prior claims of control made to the SEC and Yarmuth's and Simonelli's other positions might have been considered important by TSC shareholders, it cannot conclude that these facts were so obviously important to them that reasonable minds could not differ on the issue; that is, as to whether they would have a significant propensity to affect the voting process. *Mills*, 396 U. S. at 384. Accordingly, the motion is denied as to this ground.

B.

Plaintiff contends that the statement in the joint proxy statement that the TSC board of directors had approved the transaction was false, in violation of Rule 14a-9. It is admitted that the resolutions to approve the plan of sale, liquidation, and dissolution of TSC were presented to the board at a meeting attended by eight of the ten directors. It is further admitted that directors Noyes, Schaefer, DeForest, and Sharfman voted for the resolutions, that there were no negative votes, and that the remaining directors in attendance, Yarmuth, Solomon, Segell,

and Peterson, did not vote. Plaintiff claims that because the transaction included the dissolution of TSC, its approval required "the adoption of a resolution to that effect by a majority of the whole board . . ." as set forth in § 275(a) of the Delaware Corporation Law, 8 Del. C § 275(a). Defendants argue that § 144, which deals with the validity of the acts of directors where some have adverse financial interests or corporate duties, supersedes § 275 in this situation. Section 144 reads, in pertinent part:

> "(a) No contract or transaction between a corporation . . . and any other corporation . . . in which one or more of its directors or officers are directors or officers, or have a financial interest, shall be void or voidable solely for this reason, or solely because the director or officer is present at or participates in the meeting of the board . . . which authorizes the contract or transaction, or solely because his or his or their votes are counted for such purpose, if:
>
> (1) The material facts as to his relationship or interest and as to the contract or transaction are disclosed or are known to the board of directors . . ., *and the board . . . in good faith authorizes the contract or transaction by the affirmative votes of a majority of the disinterested directors, even though the disinterested directors be less than a quorum. . . .*" (emphasis added)

Assuming for the purpose of this motion that directors Noyes, Schaefer, DeForest, Sharfman and Peterson were disinterested, plaintiff asserts that § 144, if it is applicable, was not satisfied. Plaintiff contends that the proper procedure would have been for at least two other directors to have voted for the transaction even though they were interested. Defendants, on the other hand, read § 144 so as to make the votes of interested directors irrelevant so long as a majority vote of the disinterested directors is obtained. There are no reported decisions dealing with the recent amendments to § 144 at issue here. A noted commentator, cited by the parties on both sides, gives the following example of the application of § 144 which supports defendants' view:

> "Thus, if three of four disinterested directors on a nine-man board vote for the transactions, it is validated. In this hypothetical, it is assumed that the five interested directors (who are permitted under these [Delaware] statutes to participate in and vote at the meeting) would have voted for the transaction, so that the resolution formally passes by a vote of eight to one."

Folk, *Corporation Law Developments-1969*, 56 Va. L. Rev. 755, 782 (1970). See also Arsht & Stapleton, *Delaware's New General Corporation Law: Substantive Changes*, 23 Bus. Law. 75, 81 (1967). In the absence of contrary precedent, this construction appears to be reasonable and will be adopted here.

Plaintiff argues that § 144 is inapplicable by its terms to dissolution because it is a unilateral action rather than a contract or transaction between the corporation and others. This technical construction would not serve the apparent intent of the Delaware legislature to abrogate the common law rule of voidness of corporate action where interested directors are present or participate in board meetings. To adopt plaintiff's construction would mean that at least one of the interested directors on the TSC board would have had to make the useless gesture of voting for the transaction when it can be assumed, as in Professor Folk's example, that all of National's nominees would have so voted.

The Court concludes that plaintiff has failed to show that the transaction was not validly approved by the TSC board and accordingly denies its motion for partial summary judgment of liability on that ground.

C.

Plaintiff contends that the joint proxy statement's emphasis on market quotations for the securities to be exchanged was materially misleading as a matter of law under Rule 14a-9, in light of certain undisclosed facts.

TSC shareholders were offered one-half share of National's Series B cumulative preferred stock and one and one-half

National warrants for each of their shares of TSC common and .6 share of National's Series B cumulative preferred stock and one National warrant for each of their shares of TSC Series 1 preferred. Each full share of the National preferred was convertible into .75 share of National common, and each National warrant entitled the holder to purchase one share of National common for $21.40.

On page 10 of the joint proxy statement, in compliance with Item 14(c) of Schedule 14A, the high and low sale prices of National's common stock, Series B preferred stock, and warrants, and TSC's common stock and Series 1 preferred stock for each quarterly period in the preceding two years is set forth. Plaintiff contends that the significance of these market quotations could not be fairly evaluated without disclosure of the fact that National and Madison Fund, Inc. ("Madison") purchased 260,000 shares of National common in 1968 and 1969. Essential to plaintiff's theory is its contention that the purchases by Madison and National were coordinated. It is not disputed that the chairman of National's board of directors, Bernard Barnett, was also a director of Madison and that the president and a director of Madison, Edward Merkle, was employed by National at the time the joint proxy statement was mailed, for $12,000 per year, for performing such duties as requested by National's board for at least one day each month. It has been shown that Merkle consented (solely for the purposes of settlement) to the entry of an order by the SEC finding that he willfully violated and aided and abetted violations of § 17(a) of the Securities Act of 1933, 15 U. S. C. § 77q, § 10(b) of the 1934 Act, 15 U. S. C. § 78j(b), and Rule 10b-5 thereunder, and §§ 17(a)(3), 17(d), and 48(a) of the Investment Company Act, 15 U. S. C. § 80a-17(a)(3),-17(d) and-47, and Rule 17d-1, 17 C. F. R. § 270.17d-1, thereunder. This was based in part on the finding that Merkle caused Madison to purchase 182,500 shares of National common and National convertible bonds in the amount of $2

million without disclosing that he was a salaried employee of National, had National common stock and stock options in his personal portfolio, and sold at least 8,100 shares of National common during the period of Madison's purchases. *In re Merkle*, SEC Investment Co. Release No. 7280 (July 19, 1972).

As further evidence that the Madison and National purchases were coordinated, plaintiff notes that neither ever made purchases in the same week as the other and that Madison's purchases "were made at times of substantial benefit to National," such as when the market price of National common was used to fix the exchange ratios in other acquisitions.

In opposition, defendants point to the lack of evidence of any significant purchases of National preferred stock or warrants by National or Madison, the lack of evidence of the relationship of the market price of the National common to the preferred and the warrants, the lack of evidence of purchases by National in the period immediately prior to the mailing of the joint proxy statement, and the lack of evidence that National's and Madison's purchases had any material effect on the market price of National common at the dates given in the joint proxy statement. Defendants also assert, and support with affidavits and deposition testimony, that Yarmuth, Solomon, and Barnett only learned of Madison's purchases of National common after they took place.

Although plaintiff's evidence shows the opportunity for coordination, and the inference that might be drawn from its evidence might support a finding of coordination, the Court is not free to draw such inferences. Thus, defendants' evidence succeeds in raising a genuine issue of fact as to whether the Madison purchases were coordinated with National's. Plaintiff does not argue or cite authority showing that defendants had a duty to disclose Madison's purchases if they were simply aware of, but did not cause, the purchases. Accordingly, plaintiff's motion is denied as to its contention that the purchases of National common by Madison and National should have been disclosed in connection with the market quotations.

Plaintiff also claims that the statement on page 6 of the joint proxy statement that the favorable opinion as to the fairness of the transaction of Hornblower & Weeks-Hemphill, Noyes was based in part upon "the substantial premium over current market values represented by the securities being offered to TSC shareholders. . . ." This assertion is based, first, on the failure to disclose that Hornblower's opinion was predicated on a value of $3.50 each for the warrants, rather than the $5.25 current market price given in the joint proxy statement, and the condition that National retire $13 million of its debt. As to the latter factor, the sentence from which the allegedly misleading statement is taken also includes the statement that the debt service requirements of TSC and National were considered in reaching the opinion. Plaintiff bases its criticism of the failure to disclose that Hornblower relied upon a warrant value of $3.50 on its assertion that the use of this figure results in a very small premium, rather than the substantial one claimed. There is no evidence in the record of which the Court is aware to support this assertion. The truth of this assertion and the adequacy of the disclosure of the condition remain to be determined by the finder of fact and summary judgment on these grounds is thus precluded.

Finally, plaintiff asserts that the statement that Hornblower relied upon a premium over current market values constituted an implicit prediction as to future market values, in violation of Rule 14a-9, as exemplified in Note 1 to the Rule. Note 1 deals, however, with "specific" future market values which clearly were not predicted here. This is certainly not the same type of situation as in *Union Pac. R. R.* v. *Chicago & N. W. Ry.*, 226 F. Supp. 400, 409 (N. D. Ill. 1964), upon which plaintiff relies, where the Northwestern represented that a savings of $25 million was anticipated from a merger and that the value of the package offered by the Northwestern "should reach well above forty dollars per share" as compared with much less for a competing exchange offer. The Court concludes that the

implicit prediction of post-transaction market values here should be governed by the usual standards under Rule 14a-9 rather than upon what would amount to a *per se* test based upon Note 1 to the rule. Accordingly, as plaintiff has failed to show that the implicit prediction was materially misleading as a matter of law, its motion is denied as to this ground.

II.

As the Schmidt defendants correctly point out, this Court's memorandum opinion and order dated September 28, 1972, disposed of the only count in which they are named and in which relief is prayed against them. The Court cannot conclude, however, that there is no just reason for delay in the entry of a final judgment as to that count.

In his often-quoted opinion in *Panichella* v. *Pennsylvania R. R.*, 252 F. 2d 452, 455 (3d Cir. 1958), Judge Hastie noted that Rule 54(b) was adopted to authorize "the exercise of a discretionary power to afford a remedy in the infrequent harsh case [citation omitted]." The only hardships to which the Schmidt defendants claim they will be subjected if plaintiff is not forced to appeal is the additional delay and expense of "sitting through what will obviously be a long and protracted trial against . . . [the corporate defendants]." This is hardly the infrequent harsh case; rather, the inconvenience of which the Schmidts complain is experienced in any case where one or more defendants prevail upon their motions to dismiss or for summary judgment prior to the trial of their codefendants. An appeal of the order granting the Schmidt defendants' motion for summary judgment would only serve to delay the trial of the claims against the corporate defendants by diverting plaintiff's attorneys' energies. Because plaintiff's claims against the Schmidts depend to some extent upon the liability of the corporate defendants, the court of appeals will be presented with a more concrete record upon which to evaluate the propriety of the order of September 28 if the appeal of that order

follows the trial of the remaining issues. The Schmidt defendants have failed to show that the circumstances of this case demand that the strong policy against piecemeal appeals in this circuit, *e.g.*, *Columbia Broadcasting Sys., Inc.* v. *Amana Refrigeration, Inc.*, 271 F. 2d 257, 258 (7th Cir. 1959), *cert. denied*, 362 U. S. 298 (1960), be disregarded in this instance.

Accordingly, the motion of the Schmidt defendants is denied.

IT IS SO ORDERED.

ENTERED:

[s.] R. W. McLaren
United States District Judge.

Dated: May 21, 1973

APPENDIX C.

IN THE UNITED STATES DISTRICT COURT,
For the Northern District of Illinois, Eastern Division.

NORTHWAY, INC., a Delaware Corporation, *Plaintiff,*
vs.
TSC INDUSTRIES, INC., a Delaware corporation, *et al,* *Defendants.*
No. 69 C 2513

MEMORANDUM OPINION AND ORDER.

This matter arises upon the motions of plaintiff and the Schmidt defendants to amend this Court's orders of May 21, 1973 and September 28, 1972, by adding provisions, pursuant to 28 U. S. C. § 1292(b), that such orders involve controlling questions of law as to which there is substantial ground for difference of opinion and that an immediate appeal from the orders may materially advance the ultimate termination of the litigation. For the reasons set forth below, the motions will be granted.

In its May 21 Memorandum Opinion and Order, the Court denied plaintiff's motion for partial summary judgment of liability against the corporate defendants. In so ruling, it was recognized that several disputed questions of law were presented which, if decided in plaintiff's favor, would dictate that the motion should be granted on one or more grounds. In particular, the Court faced a difficult question of first impression under an amendment to the Delaware Corporation Law which goes to the effectiveness of the corporate action which was author-

ized by the shareholders in response to the challenged proxy solicitation. In reaching its decision on this point, the Court relied upon an example given in an article by a noted commentator. Plaintiff has now submitted a letter in which that writer states that the opinion misconstrues his example; he then goes on to explain the law in a manner which results in a conclusion favorable to plaintiff. Although the Court would have considered these views prior to ruling, it maintains its belief that the more reasonable construction is the one adopted in the opinion. The letter serves to point out, however, that there is substantial ground for difference of opinion on the issue.[1]

In its September 28 opinion and order, the Court granted the Schmidt defendants' motion for summary judgment. Certain of the allegations of the complaint were stricken for legal insufficiency, plaintiff having failed to show any authority supporting its position and the Court concluding that Rule 10b-5 should not be extended to provide a claim. On the remaining allegations against the Schmidts, the Court entered summary judgment based upon its reading of the case law in the area of aider and abettor liability. In light of the developing nature of the law in this area and the fact that no decision has specifically rejected plaintiff's theories, a substantial ground for dispute exists.

If the May 21 order is appealed, a reversal of the denial of summary judgment on any of the many grounds asserted will result in liability and may obviate the need for a trial of liability on the remaining grounds. The affirmance of the September 28 order would result in the removal of the Schmidts from this

1. Substantial ground for difference of opinion exists on several other pivotal issues. As a further example, in ruling that materiality could only be resolved in plaintiff's favor on a motion for summary judgment if it was clear that reasonable minds could not differ, it was recognized that no such requirement was imposed, on similar facts, in *Colonial Realty Corp.* v. *Baldwin-Montrose Chem. Co.,* 312 F. Supp. 1296 (E. D. Pa. 1970).

litigation; the reversal of that order prior to the continuation of the litigation in this Court would allow the claims against them to be tried along with those against the corporate defendants, rather than later.

For the reasons set forth above, the Court's May 21 and September 28 orders are hereby amended as of this date to reflect the Court's opinion that they involve controlling questions of law as to which there is a substantial ground for difference of opinion and that an immediate appeal may materially advance the ultimate termination of this litigation.[2]

IT IS SO ORDERED.

ENTERED:

{s.] R. W. McLaren
United States District Judge.

Dated: August 10, 1973

2. Defendant's contentions in regard to the timeliness of the instant motions are without merit. See Rule 5(a), Federal Rules of Appellate Procedure.

APPENDIX D.

SECURITIES EXCHANGE ACT OF 1934, SEC. 14(a), 15 U. S. C. § 78n(a).

§ 78n. Proxies.

(a) It shall be unlawful for any person, by the use of the mails or by any means or instrumentality of interstate commerce or of any facility of a national securities exchange or otherwise, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors, to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security (other than an exempted security) registered pursuant to section 78*l* of this title.

SECURITIES AND EXCHANGE COMMISSION, RULE 14a-9, 17 C. F. R. § 240.14a-9

§ 240.14a-9 False or misleading statements.

(a) No solicitation subject to this regulation shall be made by means of any proxy statement, form of proxy, notice of meeting or other communication, written or oral, containing any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading or necessary to correct any statement in any earlier communication with respect to the solicitation of a proxy for the same meeting or subject matter which has become false or misleading.

(b) The fact that a proxy statement, form of proxy or other soliciting material has been filed with or examined by the Com-

mission shall not be deemed a finding by the Commission that such material is accurate or complete or not false or misleading, or that the Commission has passed upon the merits of or approved any statement contained therein or any matter to be acted upon by security holders. No representation contrary to the foregoing shall be made.

NOTE: The following are some examples of what, depending upon particular facts and circumstances, may be misleading within the meaning of this section:

(a) Predictions as to specific future market values, earnings, or dividends.

(b) Material which directly or indirectly impugns character, integrity or personal reputation, or directly or indirectly makes charges concerning improper, illegal or immoral conduct or associations, without factual foundation.

(c) Failure to so identify a proxy statement, form of proxy and other soliciting material as to clearly distinguish it from the soliciting material of any other person or persons soliciting for the same meeting or subject matter.

(d) Claims made prior to a meeting regarding the results of a solicitation.

SECURITIES AND EXCHANGE COMMISSION, RULE 405(a), (f) and (n), 17 C. F. R. § 230.405(a), (f) and (n).

§ 230.405 Definitions of terms.

Unless the context otherwise requires, all terms used in §§ 230.400 to 230.494, inclusive, or in the forms for registration have the same meanings as in the act and in the general rules and regulations. In addition, the following definitions apply, unless the context otherwise requires:

(a) *Affiliate*. An "affiliate" of, or a person "affiliated" with, a specified person, is a person that directly, or indirectly through

one or more intermediaries, controls, or is controlled by, or is under common control with, the person specified.

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(f) *Control*. The term "control" (including the terms "controlling", "controlled by" and "under common control with") means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise.

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(n) *Parent*. A "parent" of a specified person is an affiliate controlling such person directly, or indirectly through one or more intermediaries.

FEDERAL RULES OF CIVIL PROCEDURE, RULE 56(a), (b) AND (c).

Rule 56.

SUMMARY JUDGMENT.

(a) For Claimant. A party seeking to recover upon a claim, counterclaim, or cross-claim or to obtain a declaratory judgment may, at any time after the expiration of 20 days from the commencement of the action or after service of a motion for summary judgment by the adverse party, move with or without supporting affidavits for a summary judgment in his favor upon all or any part thereof.

(b) For Defending Party. A party against whom a claim, counterclaim, or cross-claim is asserted or a declaratory judgment is sought may, at any time, move with or without supporting affidavits for a summary judgment in his favor as to all or any part thereof.

(c) Motion and Proceedings Thereon. The motion shall be served at least 10 days before the time fixed for the hearing.

The adverse party prior to the day of hearing may serve opposing affidavits. The judgment sought shall be rendered forthwith if the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law. A summary judgment, interlocutory in character, may be rendered on the issue of liability alone although there is a genuine issue as to the amount of damages.